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Sarbanes-Oxley Whistleblowers: Avoiding the Nightmare Scenario

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[1] The views expressed in this paper are those of the author and not Freddie Mac or the ACC.

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One morning, you receive an email from an attorney who alleges that a group of high-level managers—including two "rising stars" hand-picked by your CEO—have been cooking the books to improve their profit margins. The attorney says his client, a former employee, was fired for raising questions about the misconduct. The attorney wants several million dollars, and implies that the former employee is taking his story public. You also have telephone messages from the Department of Labor, the SEC, two U.S. Senate Committees, and "60 Minutes". The phone rings, but then you realize it's the alarm clock waking you up. You have been having a "SOX nightmare."

I. Introduction

The Sarbanes-Oxley Act of 2002 (SOX) extended significant new protections to millions of corporate employees, in the most far-reaching whistleblower protection law in our history. Since then, many companies have struggled to implement the law's far-reaching mandates, and their in-house counsels have lost sleep worrying about the "SOX nightmare" described above.

Yet for these same companies, the whistleblower provisions of SOX also represent an opportunity to use whistleblowers as a valuable internal early warning system for illegal conduct and other wrongdoing. An effective internal whistleblower program will allow a company to identify illegal conduct before it occurs or before it becomes catastrophic, correct the conduct internally, increase accountability, build confidence in the company among shareholders, employees and consumers, and preclude the wrongdoing from becoming a major focus of government enforcement agencies, the Congress, or the media.

This paper provides a wake-up call for in-house counsel to prevent the above-described scenario from arising. First, after six years, many of the elements of the SOX whistleblower law have been tested in litigation; this paper begins with an explanation of the law and a summary of key developments and emerging issues. Second, this paper details the most critical elements of an effective whistleblower program, and provides guidance for conducting effective investigations of whistleblower claims. Lastly, this paper also explains the ethical implications of Sarbanes-Oxley's attorney disclosure rules.

II. Sarbanes-Oxley's Whistleblower Protection Provisions

A. The Legislation

The Sarbanes-Oxley Act of 2002 was enacted on July 30, 2002, in the wake of many corporate scandals that cost billions of dollars and sapped investors' confidence in corporate governance and securities markets. Title VIII of the Act includes provisions that prohibit discrimination against corporate whistleblowers who bring to light financial and other wrongdoing. According to Secretary of Labor Elaine Chao, the law "will protect courageous workers who speak out against corporate abuse and fraud."

The Sarbanes-Oxley law includes a broad range of corporate accountability and transparency measures, including a requirement that corporate boards establish internal, independent audit committees. These audit committees must establish complaint procedures and accept anonymous complaints.[2] The law also includes provisions for enhanced financial disclosures, as well as provisions addressing auditor independence and certification of financial statements by corporate officers.

Sarbanes-Oxley's whistleblower protection provisions create broad protection for employees of publicly-held companies (and their contractors, subcontractors and agents)[3] who have a reasonable belief that fraud or other wrongdoing has occurred in violation of U.S. securities laws.[4] A range of conduct is protected, including internal complaints, communications with Congress, contacts with government agencies, and participation in investigations of securities law violations.[5] Employees who suffer reprisals for engaging in protected conduct may file administrative complaints with the U.S. Department of Labor's Occupational Safety & Health Administration (OSHA) within 90 days of the alleged discrimination. Complainants may name the company as well as specific individuals in the complaint.

OSHA is required to determine whether there is reasonable cause to believe that the complaint has merit within 60 days of the filing of the complaint. 29 C.F.R. § 1980.105. If the complaint is found to have merit, OSHA can order relief[6] including preliminary reinstatement.[7] The employee or the employer may thereafter file objections and requests for a hearing before an administrative law judge (ALJ) within 30 days. The ALJ's decision may be appealed to the DOL's Administrative Review Board (ARB) and then to the U.S. Courts of Appeals.

Sarbanes-Oxley creates a right to a *de novo* trial in federal district court if the Department of Labor is unable to issue a final order within 180 days of the filing of the complaint.[8] This feature of the Act is modeled on federal equal employment opportunity laws, and is not replicated in other federal whistleblower statutes.[9]

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[2] *See* 15 U.S.C. § 78f.
[3] The law also protects former employees and applicants. 29 C.F.R. § 1980.101.
[4] *See* 18 U.S.C. § 1514A.
[5] Employees are not required to complain to their employers first.
[6] The relief may also include back pay, attorneys fees, and other compensatory damages. Employees who bring frivolous or bad faith claims may be subject to an award of attorneys' fees of up to $1,000.
[7] Preliminary reinstatement may not be ordered if the employee poses a risk of physical violence. In the alternative, "economic reinstatement" (continued pay and benefits for the employee) may be ordered. 69 Fed. Reg. 52108-09.
[8] This provision does not apply if the delay was due in part to the complainant's own bad faith.
[9] Some whistleblowers may have access to the courts under other laws, such as the False Claims Act. 31 U.S.C. § 3729 *et seq*.

Sarbanes-Oxley also includes tough criminal provisions. One permits the Securities and Exchange Commission (SEC) to seek criminal penalties for violation of any provision of the Act.[10] Another provision increases the criminal penalties for persons who retaliate against whistleblowers who provide truthful information to a law enforcement officer about violations of federal law.[11]

The law provides that whistleblowers must prove that discrimination was a contributing factor in the challenged action by a preponderance of the evidence; in such circumstances, an employer may successfully defend against the claim only if it proves by clear and convincing evidence that it would have taken the same action against the whistleblower anyway. Ultimately, the employee bears the burden of showing by a preponderance of the evidence that the employer's proffered reasons for the challenged action are a pretext for retaliation.

This new law covers thousands of companies and millions of employees, and creates a broad new exception to the at-will employment doctrine. It is intended to benefit corporate shareholders, employees and consumers by increasing corporate accountability and transparency. In the wake of its enactment, many publicly traded companies have established new accountability policies, procedures and programs. Privately held companies and non-profits have also felt pressure to adopt measures to advance accountability and transparency.

B. The Regulations

The Department of Labor (DOL) issued final Sarbanes-Oxley regulations on August 24, 2004.[12] The new regulations took effect that day.

These regulations are drawn from those the DOL developed for the AIR 21 whistleblower provisions,[13] which provide protection for airline industry employees, as well as other existing whistleblower procedures under the Energy Reauthorization Act[14] and other whistleblower laws. According to the Department, these new Sarbanes-Oxley regulations are not intended to provide interpretations of the substantive provisions of the statute; instead, they are intended to provide the procedural rules for the handling of whistleblower complaints. 69 Fed. Reg. 52107. Nevertheless, the regulations do address some important issues regarding the scope of the new law:

- **Meeting With the Complainant.** In the regulations the DOL declares that complainants "are given ample opportunity to meet with OSHA" during the investigation of their complaints. 69 Fed. Reg. 52107. Nevertheless, some complainants have reported that they were not formally interviewed face-to-face

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[10] *See* Section 3(b) of the Act.
[11] This provision applies to every employer, not just publicly traded companies. *See* 18 U.S.C. § 1513.
[12] 69 Fed. Reg. 52103. The Department of Labor had previously issued interim final rules in May, 2003.
[13] 49 U.S.C. § 42121(b)(2)(B)(iv).
[14] 42 U.S.C § 5851(b)(3)(D).

by the OSHA investigator assigned to their case.[15] Numerous complainants have expressed concern regarding the quality of the investigation performed by OSHA.

- **Limiting Administrative Discovery.** The DOL's regulations state that administrative law judges may limit discovery in view of the time limit on DOL proceedings that triggers a jury trial right. 69 Fed. Reg. 52109. The regulations also provide that an ALJ may choose to permit discovery in some instances on the condition that the complainant agree to delay filing a complaint in federal court. 69 Fed. Reg. 52110.

- **Security Risk.** The DOL made clear that the security risk exception to the preliminary reinstatement remedy applies only when an employee's reinstatement "might pose a significant safety risk to the public" in terms of physical violence. In the event of such circumstances, the DOL may still require "economic reinstatement"—meaning that DOL may require the employer to provide the employee who suffered the reprisal with their normal compensation and benefits. 69 Fed. Reg. 52109.

- **No Participation by DOL in Most Adjudications.** The regulations make clear that at the ALJ hearing stage and beyond, complainants will have to find their own counsel. The DOL will not ordinarily participate. 69 Fed. Reg. 52110.

- **Employer Liability for Actions of Contractors.** The DOL interprets Sarbanes-Oxley to hold employers liable for the actions of their contractors when the employer acted as an employer with regard to the contractor's employee, "by exercising control of the work product or by establishing, modifying, or interfering with the terms, conditions, or privileges of employment." 69 Fed. Reg. 52107 (citing *Stephenson v. NASA*, ARB No. 96-080, ALJ No. 1994-TSC-5 (ARB April 7, 1997).

- **Waiver of Rules.** The DOL's Sarbanes-Oxley regulations permit ALJs or the Administrative Review Board to waive any provision in "special circumstances" or if good cause is shown. 29 C.F.R. § 1980.115.

C. Judicial and Administrative Decisions

As with other employee protection laws, courts and ALJs have held that the Sarbanes-Oxley Act's whistleblower protection provisions are remedial in nature, and should be broadly construed by the Department of Labor and the courts in order to encourage employees to aid in enforcement of federal securities laws. *See Harvey v. Safeway, Inc., 2004-SOX-21 (ALJ February 11, 2005); see generally Deford v. Secretary of Labor*, 700 F.2d 281, 286 (6th Cir. 1983); *see also Passaic Valley Sewerage Com'rs v. Dept. of Labor*, 992 F.2d 474, 478 (3d Cir. 1989).

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[15] Wall Street Journal, *"For Financial Whistle-Blowers, New Shield is an Imperfect One,"* Oct. 4, 2004, at A1.

In interpreting the Sarbanes-Oxley Act, administrative law judges and the courts will look to other federal whistleblower statutes for guidance. *See*, *e.g.*, *Collins v. Beazer Homes, USA, Inc.*, 2004 WL 2023716 (N.D. Ga. Sept. 2, 2004). This is partly due to the fact that Sarbanes-Oxley's whistleblower provisions are based in large part on the whistleblower provisions of other laws such as the Surface Transportation Amendments Act, the AIR 21 legislation and the Energy Reauthorization Act.

In the first three years after the enactment of the Sarbanes-Oxley law, some 491 individuals filed claims with OSHA under the law's whistleblower protection provisions. Fifty-seven of these claims (11.6%) resulted in a settlement at the OSHA level. At the ALJ level, 17 of 93 cases resulted in a settlement, a rate of 18.3%.[16]

Dozens of cases have now been filed in federal court, after exhaustion of the 180-day waiting period. In the past six years, DOL administrative law judges and the federal courts have issued numerous decisions interpreting and clarifying the scope and nature of the law's whistleblower protection provisions.[17] Some of the more significant decisions are highlighted below.

1. Scope of Coverage

- **Privately Held Subsidiaries of Publicly Traded Parents May Be Covered.** In *Gonzalez v. Colonial Bank*, 2004-SOX-39 (ALJ Aug. 9, 2004), an administrative law judge ruled that a complainant could maintain an administrative proceeding by amending his complaint to include the parent corporation, even though the subsidiary for whom he worked was not publicly traded, where both entities were responsible for the retaliatory action. *See also Collins v. Beazer Homes, USA, Inc.*, 334 F. Supp. 2d 1365 (N.D. Ga. 2004); *Gonzalez v. Colonial Bank*, 2004-SOX-39 (ALJ August 20, 2004) (allowing action against non-publicly-traded subsidiary where publicly-traded parent was also named); *Kalkunte v. DVI Financial Services, Inc.*, 2004-SOX-56 (ALJ July 18, 2005) (denying employer's motion for summary decision where retaliating official worked for non-publicly-traded company that operated as an agent of a publicly-traded company, and where both entities were named in the complaint); *Morefield v. Exelon Services, Inc.*, 2004-SOX-2 (ALJ Jan. 28, 2004); *cf. Klopenstein v. PCC Flow Technologies Holdings, Inc.*, 2004-SOX-11 (ALJ July 6, 2004) (dismissing complaint against non-publicly-traded subsidiary where publicly-traded parent was not named in complaint). The complainant must demonstrate sufficient commonality of management and purpose to justify piercing the corporate veil. *Dawkins v. Shell Chemical LP*, 2005-SOX-41 (ALJ May 16, 2005) (requiring complainant to name parent in original complaint).

[16] 96 BNA Daily Labor Report C-1 (May 18, 2007).

[17] The first ALJ decision under Sarbanes-Oxley occurred in *Welch v. Cardinal Bankshares Corp*., No. 2003-SOX-15 (ALJ July 19, 2004). The ALJ concluded that the complainant was terminated in retaliation for disclosing accounting irregularities. The DOL Administrative Review Board later reversed the decision. ARB Case No. 05-064 (5/31/07).

- **Mixed Decisions On Extraterritorial Application.** Several SOX decisions have held that Section 806 does not have extraterritorial application to employees working outside the U.S. *Carnero v. Boston Scientific Corp.*, 433 F.3d 1 (1st Cir. 2006); *Ede v. The Swatch Group Ltd.*, ARB No. 05-053(6/27/07) (adverse actions occurred outside U.S. during employment with foreign subsidiaries of U.S. firm); *Concone v. Capital One Financial Corp.*, 05-SOX-06 (ALJ December 3, 2004); *Ede v. Swatch Group*, 2004-SOX-68 (ALJ January 14, 2005). More recently, in *O'Mahony v. Accenture*, No. 07-Civ. 7916 (S.D.N.Y. Feb. 5, 2008), the court reached a different conclusion, and sought to distinguish the First Circuit's *Carnero* decision. In *O'Mahony*, the plaintiff charged that although she was working in France for Accenture, the allegedly retaliatory decision to demote her was made by an Accenture executive in the U.S., after she objected to the company's failure to make French social security payments on her behalf, a fraud she also alleged to have occurred in the U.S. The court found SOX to be applicable on that basis, and also noted that O'Mahony was employed in France by a U.S. rather than a foreign subsidiary.

- **Limited Coverage of Contractors.** Section 806's coverage of publicly-traded companies' contractors and agents only extends to those entities that retaliate against a publicly-traded company's employee on behalf of the publicly-traded company; it does not extend to all contractors and agents or their employees. *Brady v. Calyon Securities (USA)*, 2005 U.S. Dist. LEXIS 27130 (S.D.N.Y. Nov. 8, 2005) at *23-*26; *Goodman v. Decisive Analytics Corp.*, 2006-SOX-11 (ALJ Jan. 10, 2006).

- **SOX Claims Not Exempt From Mandatory Arbitration Agreements.** In *Boss v. Salomon Smith Barney Inc.*, 263 F. Supp. 2d 684 (S.D.N.Y. 2003), a federal court held that an investment firm employee's SOX claim was subject to arbitration under the employee's securities industry registration with the NASD. The registration requires all employment disputes to be resolved through arbitration. The court reasoned that "[t]here is nothing in the text of the statute or the legislative history of the Sarbanes-Oxley Act evincing intent to preempt arbitration of claims under the Act. Nor is there an inherent conflict between arbitration and the statute's purposes." *Id*. at 685.

2. Defining Protected Activity.

In a number of cases administrative law judges have begun to define the scope of protected activity under Sarbanes-Oxley.

- **Requirement of Intentional Fraud on Shareholders.** Earlier this year, the Fifth Circuit held that a SOX complainant must demonstrate an objectively reasonable belief that the employer "acted with a mental state embracing intent to deceive, manipulate, or defraud its shareholders." *Allen v. Admin. Review Bd.*, No. 06-60849 (5th Cir. 1/22/08) (employees' complaints regarding accounting problems did not rise to the level of protected activity under SOX); *see also Livingston v. Wyeth Inc.*, No. 06-1939 (4th Cir. 3/24/08) (no SOX claim where plaintiff failed to show company misrepresented or concealed anything or intended to mislead shareholders); *Harvey v. Home Depot*, ARB Nos. 04-114, 04-115 (6/2/06) (complaints about personnel actions, discriminatory practices, questionable expenditures, or violations of employment laws is not by itself protected activity under SOX 806). Similarly, in *Hopkins v. ATK Tactical Systems*, 2004-SOX-19 (ALJ May 27, 2004), the ALJ found that the complainant's disclosure of an allegedly illegal release of sludge water into a ground water system was not protected, because it did not constitute or result in a fraud on shareholders. The ALJ concluded that an element of intentional deceit by the respondent is implicit in the concept of fraud under Sarbanes-Oxley. *See also Reddy v. Medquist, Inc.*, 2004-SOX-35 (ALJ June 10, 2004) (challenges to internal company policies not covered where no violation of federal law alleged); *Minkina v. Affiliated Physicians Group*, 2005-SOX-19 (ALJ February 22, 2005) (OSHA complaint regarding indoor air quality did not implicate shareholder fraud).

- **Some Specificity Required as to Facts, But Not Laws Violated.** In *Lerbs v. Buca Di Beppo, Inc.*, 2004-SOX-8 (ALJ June 15, 2004), an ALJ held that for a whistleblower disclosure to be protected under Sarbanes-Oxley, the reported information must have a certain degree of specificity. Thus, the ALJ reasoned, general inquiries about the propriety of certain transactions without identification of particular concerns was insufficient. *See also Walton v. Nova Info. Sys.*, 514 F. Supp. 2d (E.D. Tenn. 2007) (employee's complaints regarding database security were "too speculative for a reasonable belief of a violation of securities laws"); *Harvey v. Safeway, Inc.*, 2004-SOX-21 (ALJ February 11, 2005) (dismissing SOX claim alleging FLSA complaints as protected activity; to support assertion that systemic FLSA violations constituted shareholder fraud, complainant offered only facts pertaining to his own pay). At the same time, in *Hendrix v. American Airlines, Inc.*, 2004-SOX-23 (ALJ December 9, 2004), the ALJ concluded that SOX does not require the complainant to identify a particular securities law provision he or she believed to have been violated. It is insufficient, however, simply to allege violations of internal corporate policies or ethics rules. *Hunter v. Northrop Grumman Synoptics*, 2005-SOX-8 (ALJ June 22, 2005).

- **Evaluating the Reasonableness of the Complainant's Belief.** SOX protects only those who make disclosures with a "reasonable belief" that the conduct in question represents shareholder fraud or other violations of securities laws. This inquiry requires scrutiny of the objective reasonableness of the employee's belief. *See Allen v. Admin. Review Bd.*, No. 06-60849 (5th Cir. 1/22/08); *Livingston v. Wyeth Inc.*, No. 06-1939 (4th Cir. 3/24/08); *Hunter v. Northrop Grumman Synoptics*, 2005-SOX-8 (ALJ June 22, 2005) (using both subjective and objective standards).

- **ALJs Split Over Applicability of Materiality Requirement in Assessing the Reasonableness of the Complainant's Belief.** In several early cases, ALJs have reached different conclusions about whether the materiality of the alleged violation under securities law is relevant to the "reasonable belief" determination. In *Henrich v. Ecolab, Inc.*, No. 2004-SOX-51 (November 23, 2004), an ALJ found that SOX included no materiality requirement. In that case, the ALJ concluded that the company's incorrect characterization of $300,000 of inventory could serve as the basis for a reasonable belief that a securities law violation had occurred, even though the company's sales exceeded $4 billion per year. In a different case, another ALJ concluded that a corporate employee's SOX complaint was barred because the alleged violations were insufficiently material to serve as the basis of a reasonable belief that shareholder fraud had occurred. *Harvey v. The Home Depot, Inc.*, 2004-SOX-20 (ALJ May 28, 2004) (while company's failure to disclose class action alleging systemic employment discrimination might reach the requisite materiality threshold under Sarbanes-Oxley in terms of the impact of potential liability on a corporation's financial condition, failure to disclose individual discrimination claims would not). *See also Smith v. Hewlett-Packard Co.*, 2005-SOX-88 (ALJ Jan. 19, 2006). Similarly, in *Harvey v. Safeway, Inc.*, 2004-SOX-21 (February 11, 2005), an ALJ concluded that while systemic FLSA violations might be material enough to implicate shareholder fraud, individual FLSA violations "fail to reach the requisite level of materiality." The circumstances under which worker safety and health risks, product liability problems, consumer fraud, and violations of environmental and employment laws are deemed to affect shareholder value may be defined in future cases, and it seems likely that ALJs and the courts will turn to the securities law concept of materiality for help.[18] *See also Hunter v. Northrop Grumman Synoptics*, 2005-SOX-8 (ALJ June 22, 2005) (falsification of report was not sufficiently material to constitute a fraud on shareholders). In one recent case, an ALJ held that the complainant's allegations of widespread environmental violations did not constitute protected activity in the absence of pending or contemplated government enforcement actions. *Nixon v. Stewart & Stevenson Services, Inc.*, 2005-SOX-1 (ALJ February 16, 2005).

- **Proof of Illegality Not Required.** In *Halloum v. Intel Corp.*, 2003-SOX-7 (ALJ Mar. 4, 2004), the ALJ observed that "[a] belief that an activity was illegal may be reasonable even when subsequent investigation proves a complainant was entirely wrong. The accuracy or falsity of the allegations is immaterial; the plain language of the regulations only requires an objectively reasonable belief that shareholders were being defrauded to trigger the Act's protections." Slip op. at 15 (footnote omitted). *See also Klopfenstein v. PCC Flow Techs Holdings, Inc.*, No. 04-149 (ARB 5/31/06); *Kalkunte v. DVI Financial Services, Inc.*, 2004-SOX-56 (ALJ July 18, 2005).

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[18] *See, e.g., TCS Industries, Inc. v. Northway*, 426 U.S. 438, 448-49 (1976) (information is material if a reasonable person's judgment would be changed by the information).

3. Defining Retaliatory Action.

- **Supreme Court's *Burlington* Decision Resolves ALJ Split Over Scope of Prohibited Conduct.** In interpreting what constitutes prohibited retaliation under SOX Section 806, ALJs and the courts initially looked to the definition of an "adverse employment action" under Title VII of the Civil Rights Act of 1964. Thus, early SOX decisions reflected the split in the federal circuit courts of appeals on this issue in Title VII cases; some SOX decisions limited the scope of prohibited conduct to terminations, demotions, and other employment actions that have an adverse economic impact on the complainant, while others took a broader view that Sarbanes-Oxley prohibits any retaliatory employment action that is reasonably likely to deter employees from making protected disclosures. *Compare Halloum v. Intel Corp.*, 2003-SOX-7 (ALJ Mar. 4, 2004) (adopting broad definition); *Hendrix v. American Airlines, Inc.*, 2004-SOX-23 (ALJ December 9, 2004) (placement of complainant on preliminary layoff list constituted adverse action), *with Dolan v. EMC Corp.*, 2004-SOX-1 (ALJ Mar. 24, 2004) (negative performance evaluation was not an adverse employment action where it had no tangible job detriment); *Willis v. Vie Financial Group, Inc.*, No. Civ. A. 04-0435 (E.D. Pa. Aug. 6, 2004) (loss of job responsibilities did not constitute retaliatory action covered by Sarbanes-Oxley unless it constituted a material and adverse change in working conditions). This split was resolved by the U.S. Supreme Court in *Burlington N. Santa Fe Ry. Co. v. White*, No. 05-259 (6/22/06). In that Title VII retaliation case, the Court held that retaliation includes any action which would dissuade a reasonable worker from bringing a complaint.

- **SOX Prohibits Creation of a Hostile Work Environment.** In *Hendrix v. American Airlines, Inc.*, 2004-SOX-23 (December 9, 2004), an ALJ concluded that SOX prohibits employers from creating a hostile work environment as a form of retaliation against whistleblowers, if 1) the harassing conduct was sufficiently severe or pervasive so as to alter the conditions of employment, and 2) the harassment would have detrimentally affected a reasonable person and did so affect the complainant. In *Hendrix*, however, the ALJ found that the facts alleged by the complainant—verbal abuse, assignment to the second shift, and denial of computer resources—caused the complainant no hardship and did not constitute a hostile work environment. *See also Allen v. Stewart Enterprises, Inc.*, 2004-SOX-60 (ALJ February 15, 2005).

- **SOX Prohibits Constructive Discharge.** An ALJ applied the constructive discharge theory to a SOX claim in *Harvey v. Safeway, Inc.*, 2004-SOX-21 (February 11, 2005) (concluding that facts did not support finding of constructive discharge). As in other contexts, the standard for constructive discharge is whether the employer made the employee's working conditions "so intolerable that a reasonable employee would feel compelled to resign." *Id.*

- **No Retroactive Application to Pre-Enactment Retaliation.** The Sarbanes-Oxley law does not apply to retaliatory action that occurred prior to the effective date of the law. It may cover protected activity that occurred prior to the effective date of the law. *McIntyre v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 2003-SOX-23 (ALJ Jan. 16, 2004); *Lerbs v. Buca Di Beppo, Inc.*, 2004-SOX-8 (ALJ June 15, 2004).

4. Procedural Issues

- **Statute of Limitations.** The 90-day filing requirement provided by SOX begins to run when the employer communicates the adverse employment decision to the complainant, even if the decision takes effect at a later point in time. *McClendon v. Hewlett-Packard Co.*, 2005 U.S. Dist. LEXIS 29449 (D. Idaho Oct. 27, 2005) at *9.

- **Burdens of Proof.** In *Collins v. Beazer Homes, USA, Inc.*, 334 F. Supp. 2d 1365 (N.D. Ga. 2004), the court stated that a Sarbanes-Oxley plaintiff must show by a preponderance of the evidence that the plaintiff's protected activity was a contributing factor in the unfavorable personnel action alleged in the complaint. *See* 49 U.S.C. § 42121(b)(2)(B)(iii). The court noted that the plaintiff must show that (1) the plaintiff engaged in protected activity; (2) the employer knew of the protected activity; (3) the plaintiff suffered an adverse personnel action; and (4) circumstances exist to suggest that the protected activity was a contributing factor to the unfavorable action. Proximity in time between the protected activity and the adverse employment action is sufficient to raise an inference of causation, the court held. The court also stated that the defendant employer may avoid liability if it can demonstrate by clear and convincing evidence that it "would have taken the same unfavorable personnel action in the absence of [protected] behavior." *Collins*, 334 F. Supp. 2d 1365 (N.D. Ga. 2004); *see also* 49 U.S.C. § 42121(b)(2)(B)(iv); *Hendrix v. American Airlines, Inc.*, 2004-SOX-23 (ALJ December 9, 2004).

- **Decisions Split Over Availability of Jury Trial Rights.** Some federal courts have held that SOX Section 806 provides no jury trial right. *See Schmidt v. Levi Strauss & Co.*, No. C-04-01026 (N.D. Cal. 3/28/08); *Walton v. Nova Info. Sys.*, 514 F. Supp. 2d (E.D. Tenn. 2007); *Murray v. TXU Corp.*, 2005 U.S. Dist. LEXIS 10945 (N.D. Tex. June 7, 2005). In *Murray*, the court concluded that SOX does not allow damages for loss of reputation, and that jury trials are thus precluded. The court reasoned that the statutory phrase "action at law" does not automatically trigger a jury trial right, and that the statute did not expressly mention any legal remedies. *Id*. at *3. Nevertheless, in other cases courts and ALJs appear to have reached a different conclusion, that the right to a trial by jury attaches whenever the plaintiff seeks "legal" remedies such as damages for pain and suffering or loss of reputation (as opposed to purely "equitable" remedies such as back pay and reinstatement). Since SOX Section 806 authorizes claimants to bring "an action at law or equity" in federal court if the Department of Labor fails to resolve their claims within 180 days, and specifically authorizes the recovery of compensatory damages (18 U.S.C. § 1514A(c)), these authorities have held that legal damages for loss of reputation and pain and suffering are available under SOX, implying that jury trials are available as well where such damages are sought. *See Hanna v. WCI Communities, Inc.*, 348 F. Supp. 2d 1332-33 (S.D. Fla. 2004) ("a successful Sarbanes-Oxley Act plaintiff cannot be made whole [as the statute expressly provides] without being compensated for damages for reputational injury that diminished plaintiff's future earning capacity"); *Bechtel v. Competitive Technologies, Inc.*, 2005-SOX-34 (ALJ March 29, 2005) (awarding $90,000 in damages to former executive for loss of reputation, compromised ability to find work, and pain and suffering); *McClendon v. Hewlett-Packard Co.*, 2005 WL 1421395 (D. Idaho June 9, 2005) at *6 (denying employer's motion to strike plaintiff's demand for emotional distress damages and a jury trial, because the plaintiff's SOX claim was still viable).

- **Preventing Duplicative Litigation.** The DOL reports that most of the administrative complainants who have filed complaints in federal court have done so prior to the administrative hearing, and that upon the filing of a complaint in court administrative law judges have dismissed the complainant's request for an administrative hearing. *See*, *e.g.*, *Albrecht v. Chevron Texaco*, *Chevron Production Co.*, 2005-SOX-32 (ALJ June 16, 2005); *Corrada v. McDonald's Corp.*, 2004-SOX-7 (ALJ Jan. 23, 2004). In addition, when an ALJ has issued a decision on a SOX claim, and the complainant subsequently files suit in federal court, the court may apply res judicata (claim preclusion) or collateral estoppel (issue preclusion) principles. Those principles would not apply, however, to OSHA's preliminary findings based on its initial investigation. *Hanna v. WCI Communities, Inc.*, 348 F. Supp. 2d 1322, 1331 (S.D. Fla. 2004) ("preliminary orders are issued solely on the basis of an investigation of facts that OSHA deems relevant," and do not by themselves reflect a full and fair opportunity to litigate a claim).

- **Simultaneous DOL and State Court Actions.** In another ruling, an administrative law judge allowed a complainant to continue with an administrative proceeding under Sarbanes-Oxley even after filing a state court complaint in Florida for violation of that state's whistleblower law, primarily on the grounds that the two laws were materially different. *Gonzalez v. Colonial Bank*, 2004-SOX-39 (ALJ Aug. 9, 2004).

- **Issue Preclusion.** After a DOL ALJ ruled that a SOX complainant was discharged for falsifying sales reports, and not in retaliation for protected activity, a federal court in a related age and sex discrimination case found that the doctrine of issue preclusion required dismissal of the former employee's discrimination claims. *Tice v. Bristol-Meyers Squibb Co.*, 515 F. Supp. 2d 580 (W.D. Pa. 2007).

5. Remedies

- **Reinstatement Orders.** In *Bechtel v. Competitive Technologies, Inc.*, 448 F.3d 469 (2006), the Second Circuit held that the district court had exceeded its jurisdiction when it enforced an OSHA order requiring preliminary reinstatement of two corporate executives during the pendency of their SOX administrative appeals at the Department of Labor. The appeals court found no SOX provision that authorized federal courts to enforce preliminary orders of the DOL. In another case, an ALJ fined the employer $70,800 in administrative sanctions for refusing to reinstate the complainant after OSHA issued a preliminary reinstatement order and the ALJ denied the employer's motion for a stay. *Windhauser v. Trane, an Operating Division of American Standard, Inc.*, 2005-SOX-17 (ALJ June 1, 2005) (awarding complainant twice his lost wages for employer's intransigence). The DOL's Administrative Review Board (ARB) reversed and concluded that the ALJ lacked the authority to issue such sanctions. ARB No. 05-127 (10/31/07).

- **Duty to Mitigate Damages.** In *Kalkunte v. DVI Financial Services, Inc.*, 2004-SOX-56 (July 18, 2005), an ALJ stated that SOX complainants, like other complainants, have a duty to mitigate damages. The ALJ concluded that "rejection of the unconditional job offer [of reinstatement] ends the accrual of back pay liability."

- **Front Pay.** Front pay is available to successful SOX complainants to compensate for loss of future earnings the complainant would have received but for the unlawful retaliation. *Kalkunte v. DVI Financial Services, Inc.*, 2004-SOX-56 (ALJ July 18, 2005) (awarding $150,000 in front pay). For example, in one ALJ decision the ALJ concluded that the complainant's rejection of a reinstatement offer was "objectively reasonable" given the hostility the company's managers had showed to him; the ALJ awarded the complainant ten years of front pay amounting to over $640,000. *Hagman v. Washington Mutual Bank Inc.*, 2005-SOX-00073 (ALJ 12/19/06). A key consideration was that even after the company admitted that retaliation had occurred, it had not changed its retaliation policies.

- **Courts Split Over Availability of "Loss of Reputation" or "Pain and Suffering" Damages.** In *Murray v. TXU Corp.*, 2005 U.S. Dist. LEXIS 10945 (N.D. Tex. June 7, 2005), a federal court held that SOX does not permit recovery of damages for loss of reputation or pain and suffering. Nevertheless, in *Bechtel v. Competitive Technologies, Inc.*, 2005-SOX-34 (March 29, 2005), an ALJ awarded $90,000 to one of the complainants for loss of reputation, compromised ability to find work, and pain and suffering. *See also Hanna v. WCI Communities, Inc.*, 348 F. Supp. 2d 1332-33 S.D. Fla. 2004) ("a successful Sarbanes-Oxley Act plaintiff cannot be made whole [as the statute expressly provides] without being compensated for damages for reputational injury that diminished plaintiff's future earning capacity"); *Kalkunte v. DVI Financial Services, Inc.*, 2004-SOX-56 (ALJ July 18, 2005) (awarding $22,000 in damages for pain and suffering).

- **No Punitive Damages.** In *Murray v. TXU Corp.*, 2005 U.S. Dist. LEXIS 10945 (N.D. Tex. June 7, 2005), a federal court held that SOX does not permit recovery of punitive damages. *See also Hanna v. WCI Communities, Inc.*, 348 F. Supp. 2d 1332-33 S.D. Fla. 2004).

- **Settlements With "No Rehire" Clauses.** In 2007, OSHA announced that while it had previously accepted whistleblower claim settlements that included a "no rehire" clause, the agency would henceforth review such clauses on a case-by-case basis to ensure that they "are consistent with the underlying purposes of our whistleblower protection programs." The agency said it would consider such factors as the scope of the waiver, the amount of compensation, the strength of the employer's case, whether the employee had counsel, and other factors. 145 BNA Daily Labor Report A-1 (July 30, 2007).

III. The Sarbanes-Oxley Whistleblower as an Early Warning System

A. Seeing Sarbanes-Oxley as an Opportunity in Addition to a Mandate

Time magazine declared 2002 to be "the year of the whistleblower," featuring whistleblowers Sherron Watkins (Enron), Cynthia Cooper (Worldcom) and Colleen Rowley (FBI) on the cover as persons of the year. It is noteworthy that each of these whistleblowers attempted to bring wrongdoing to light *within* their organizations, only to be discredited and punished. None sought the limelight, none sought money; each sought to have the wrongdoing stopped and the problem corrected, for the good of the institution.

For institutional leaders, the lesson learned is that many whistleblowers would prefer to work within their organizations rather than triggering a media frenzy, a federal agency investigation, or congressional hearings. Thus, institutions with effective whistleblower programs can use such programs to identify internal problems early, minimize the harm resulting from such problems, protect their institutional integrity, and preserve their reputation in the larger community. In this sense, the focus on corporate governance and accountability stemming from the many business scandals of the past several years has brought not only new regulatory mandates, but a true opportunity for corporate leaders to recognize and take advantage of this critical early warning system.

B. Effective Practices in Whistleblower Protection Programs

Of course, the whistleblower phenomenon will serve as an effective early warning system only if whistleblowers come forward, and they will come forward only if there is a sufficient guarantee against reprisal. This section sets forth the elements that companies may wish to consider in developing effective whistleblower protection programs:

- **Establish Credibility**. Past evidence suggests that there are two primary reasons employees consider but decide against disclosing illegal conduct: they fear that their disclosure will not result in correction of the illegal or harmful conduct, and they fear retaliation. Thus, to generate credibility and be effective, a whistleblower program must demonstrate that a disclosure 1) will lead to the elimination of illegal conduct, and 2) will not result in retaliatory action against the whistleblower. Methods of building trust include 1) setting the ground rules up front, 2) being a good listener, 3) handling the disclosure in a responsive, reliable and timely manner, 4) letting the whistleblower decide whether and to what extent to remain anonymous, and 5) keeping promises made to the whistleblower.

- **Provide Visible Personal Leadership**. Active leadership and commitment by an organization's CEO can be a highly effective means of building trust with employees and encouraging them to come forward when they observe illegal conduct. Such leadership suggests to employees that a whistleblower program is a business priority rather than merely something required for legal compliance.

- **Extend Broad Coverage**. Cover all disclosures of illegality, abuse of power or wrongdoing, without unnecessary restrictions on form, context or audience. Consider extending protection to employees who are about to make a disclosure or who are perceived as whistleblowers.

- **Put in Place a Broad Prohibition Against Retaliation**. Prohibit all forms of discrimination against and harassment of whistleblowers. Some forms of discrimination and harassment may not constitute a tangible job action, but if allowed, it will strongly discourage employees from stepping forward to bring an end to misconduct.

- **Identify Problems Early**. Encourage the early identification of concerns regarding illegal conduct before the involved parties become polarized or, if possible, before any illegality occurs. Provide employees with a right to refuse to violate the law.

- **Protect Confidentiality.** Protect whistleblowers' identity to the extent practicable. Provide channels for anonymous disclosures, as required by Sarbanes-Oxley.

- **Create an Independent, Neutral Forum**. The most obvious avenue for whistleblowers to make disclosures is through the corporate audit committee required by Sarbanes-Oxley. If that avenue is impractical due to the size of the employer or for other reasons, other independent, neutral channels should be developed in which a problem-solving focus can be applied. Those administering any such mechanism must have sufficient expertise, capacity and authority to protect the whistleblower and to resolve the concerns in an appropriate manner. In some cases employers have had success using employee hotlines, establishing an ombudsman, creating an ethics office, or developing a special program for employee concerns, which might be based on an alternative dispute resolution mechanism such as mediation or arbitration. An example of a successful alternative dispute resolution mechanism for resolving whistleblower concerns is discussed in the next section. Whatever the process, do not require employees to waive their legal rights in order to participate in it.

- **Train Managers and Employees**. Most first-line managers are unprepared for a whistleblower complaint; many feel threatened, react defensively, and may be prone to retaliation. This leads to escalating polarization and makes a quick resolution more difficult. Train managers to recognize circumstances in which retaliation may occur and take appropriate preventive actions. Also employees about their rights and responsibilities.

- **Provide Comprehensive Relief**. Provide comprehensive relief to whistleblowers acting in good faith who have suffered reprisals. Consider the best means of restoring their careers, such as granting a transfer preference or providing career counseling. If possible, publicly recognize the contribution of whistleblowers to maintaining the company's integrity; this will send a strong signal to all employees and help build confidence and trust in the program.

- **Hold Wrongdoers Accountable**. Ensure that wrongdoers and those engaging in reprisals against whistleblowers are held fully accountable for their actions. Take disciplinary action up to and including termination.

C. Effective Practices in the Investigation of Whistleblower Claims

The investigative process is a critical part of an effective whistleblower program; it can demonstrate the company's appreciation of good faith whistleblowers, or it can signal to employees that their claims will not be taken seriously. The following practices will help give employees reason to use the system.

- **Set the Ground Rules Up Front**. Inform the whistleblower as to how the investigation process will work. Explain what the company can do to protect the whistleblower, and what the company cannot do. For example, discuss the extent to which the company will keep the employee's identity confidential if the employee comes forward with information of wrongdoing.

- **Build Trust Up Front**. Whistleblowers need support and guidance, and they need someone to really listen to their concerns. Many try to air their concerns internally and turn to external complaint mechanisms (government agencies, the media, Congress) only because no one is listening to them inside the organization. An early demonstration of trustworthiness can help establish the basis for a good working relationship with the whistleblower and a productive investigation. Make clear to whistleblowers that they will not suffer retaliation for coming forward in good faith.

- **Treat Whistleblowers as People**. Often whistleblowers feel like "objects of evidence" during an investigation. Don't forget that for an employee, disclosing evidence of wrongdoing by superiors is often a harrowing experience even if no retaliation ever occurs. Normally composed employees may be significantly agitated during an investigation, and fearful for their jobs and their careers. Extra care should be taken to reassure and support an employee who comes forward in good faith to bring illegal conduct to light.

- **Expedite the Investigation and Decisionmaking**. Whistleblowers want most to see the wrongdoing they have brought to light addressed in a timely fashion.

- **Maintain Confidentiality to the Extent Possible**. Notify the whistleblower in advance if a disclosure of his or her identity or information is necessary. Do not discuss the investigation with anyone who does not have a direct and important need to know the information.

- **Be Thorough and Objective.** When investigating a claim of retaliation, do not prejudge the result or jump to conclusions, and be sure to demonstrate impartiality. Obtain a written statement from the whistleblower. Explore each relevant incident, and determine when and where it occurred, what happened, and who saw the incident. Interview all relevant witnesses and review all pertinent documents. Keep accurate notes of all interviews.

- **Discuss the Evidence With the Whistleblower**. Often investigators question the whistleblower and record his or her answers, but do not discuss the evidence with the whistleblower in any manner. Discussing how the facts fit together, and other issues raised by the investigation, can help develop the whistleblower's trust, may result in disclosure of additional relevant information the whistleblower had unintentionally omitted from initial disclosures, and can serve as a means of assessing the whistleblower's credibility and reliability.

- **Provide the Parties With Opportunities to Respond**. Provide the wrongdoer and/or retaliator with opportunities to respond to the evidence offered by the whistleblower. Provide the whistleblower the same opportunities to respond to evidence offered by the wrongdoer or retaliator. This will ensure that all relevant evidence and information is gathered, and help to build trust with the whistleblower.

- **Keep the Whistleblower Apprised of Developments**. Inform the whistleblower as to the progress of the investigation and any preliminary findings.

- **Allow a Liaison Role**. If an investigator builds sufficient trust with a whistleblower, the whistleblower may be willing to serve as a "liaison" to other employees, helping to persuade other witnesses to come forward and make disclosures to the investigator.

- **Recognize Whistleblowers**. Recognize the good faith whistleblower for coming forward at significant personal risk to make a disclosure, even if the conduct questioned by him or her turns out to be lawful.

- **Provide Follow-Up**. After the investigation has been concluded, stay in contact periodically with the whistleblower to ensure that no retaliation or further wrongdoing has occurred.

IV. Legal Ethics Issues Under Sarbanes-Oxley

The Sarbanes-Oxley Act of 2002 established a host of new corporate governance accountability requirements in the wake of a series of major corporate financial scandals. One provision of the law, Section 307, requires attorneys practicing before the Securities and Exchange Commission ("SEC") to disclose information regarding corporate wrongdoing to the corporation's officers and directors. This provision is discussed below.

A. SOX Section 307.

Section 307 of the Sarbanes-Oxley Act required the SEC to promulgate standards of professional conduct for attorneys appearing and practicing before the Commission on behalf of regulated corporations ("issuers"). This provision specified that the SEC rules should include a provision requiring such attorneys to report evidence of a material violation of securities law, or a breach of fiduciary duty, to the corporation's chief legal counsel or chief executive officer. In addition, the rules must also require the attorney to disclose such information to the corporation's Board of Directors or Board Audit Committee if the response from the chief legal or executive officer is not "appropriate."

B. SEC Final Rule: Reaching Beyond Securities Law Practitioners.

On January 23, 2003 the SEC issued final regulations defining the scope of the attorney disclosure obligation set forth in SOX Section 307. 17 CFR Part 205. Although SOX Section 307 is expressly limited to attorneys who "appear and practice" before the SEC, the SEC has defined this language quite broadly to include attorneys "who advise that, under the federal securities laws, a particular document need not be incorporated into a filing, registration statement or other submission to the Commission." The reach of this definition is unclear, but it could extend to non-securities attorneys who respond to auditors' letters or prepare a segment of an SEC filing. Notably, the ABA proposed limiting the definition to securities practitioners, and the SEC rejected that proposal.

C. Disclosure Obligation.

Section 205.3(b) of the SEC Rules restates the general disclosure obligation. This section also provides that upon receipt of information of a material violation, the chief legal officer must investigate and take "all reasonable steps" to ensure that the company addresses the violation (unless no violation is found). 17 CFR § 205.3(b)(2). If the disclosing attorney believes that the company's response is inadequate, he or she is required to notify the officers or directors to whom the disclosure was made of the reasons for this belief. *Id*. at § 205.3(b)(9). In addition, if the attorney thinks disclosure to the GC or CEO would be futile he or she may proceed to disclose the information to the Board or Audit Committee. *Id*. at § 205.3(b)(4).

Section 205.3(c) permits attorneys to report evidence of violations to a "qualified legal compliance committee" in lieu of reporting to officers and directors.

Section 205(b)(6) incorporates the two exceptions provided in ABA Model Rule 1.13 (see below). Thus, reporting up-the-ladder is not required when the lawyer is retained by the chief legal officer or legal compliance committee to investigate an alleged violation of law or defend the company against a claim involving an alleged violation of law, ***provided*** that the chief legal officer is advising the Board, Audit Committee or legal compliance committee as to any wrongdoing, violations or litigation relating thereto.

D. Permissive Disclosure to the SEC.

SEC Rules Section 205.3(d) provides that an attorney appearing and practicing before the SEC "may" reveal confidential information to the SEC to the extent necessary to a) prevent a material violation that is likely to cause substantial harm to the issuer or investors, b) prevent perjury or fraud in an SEC proceeding, or 3) rectify the consequences of a material violation. The SEC noted in issuing the regulations that this provision corresponds to ABA Model Rule 1.6 (Confidentiality of Information) as adopted by the majority of states. *See* ABA Model Rule 1.6(b)(2) (permitting disclosure of information necessary to prevent client from committing crime or fraud that would cause substantial injury to another).

E. ABA Model Rule 1.13.

The notion that an attorney may have an obligation to disclose a client's wrongdoing did not originate with the Sarbanes-Oxley Act. The American Bar Association's Model Rules of Professional Conduct include a provision which addresses this issue. Model Rule 1.13(b), entitled "Organization as Client," was strengthened in recent years and currently provides as follows:

> *If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.*

Rule 1.13(c) provides that if the higher authority fails to act to address a clear violation of law that is reasonably certain to result in a substantial injury to the organization, the lawyer "may" disclose the wrongdoing, but only to the extent necessary to prevent substantial injury to the organization. This disclosure is permitted even if the information could not otherwise be disclosed under Model Rule 1.6 (Confidentiality of Information). Rule 1.13(d) includes two exceptions: the disclosure obligation does not apply if the lawyer is investigating an alleged violation of law, or is defending the company against a claim involving an alleged violation of law.

F. No Mandated Breach of Attorney-Client Privilege or Confidentiality Rules.

The SOX disclosure requirement and the SEC regulations have been criticized for conflicting with state ethics rules regarding the attorney-client privilege and confidentiality of information. The express terms of Section 307 and the SEC rules only mandate disclosure to the corporate client. Thus, the SEC rules state that "[b]y communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer." 17 CFR § 205.3(b). Nevertheless, Section 205.3(d) of the SEC rules permits external disclosures to the SEC in certain circumstances, and could conflict with state ethical codes requiring confidentiality. Section 205.1 of the SEC regulations states that the SEC's standards govern if there is a conflict with a state provision.