Seven Questions For Sarbanes-Oxley Whistleblowers To Ask

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Now that there is some law on point, it is a little easier to craft an appropriate whistleblower claim.

CURRENT AND FORMER corporate employees have frequently brought Sarbanes-Oxley ("SOX") whistleblower retaliation claims, pursuant to 18 U.S.C. §1514A, alleging that their employers terminated or otherwise retaliated against them for having blown the whistle on corporate fraud and misconduct. Although SOX was enacted just a little over five years ago, several hundred employees have asserted its protection, either with the U.S. Department of Labor or the federal courts, and even more have made SOX claims in demand letters and other non-judicial attempts to resolve their legal claims.

SOX claims are initiated by filing an administrative complaint with the U.S. Department of Labor ("DOL"), Occupational Safety and Health Administration ("OSHA"), which makes an initial determination that can be, and usually is, appealed to an Administrative Law Judge ("ALJ"), who either holds an evidentiary hearing after discovery, or rules on the employer's dispositive motion. The ALJ's decision can be appealed to the Administrative Review Board ("ARB"), and that decision can, in turn, be appealed to the U.S. Court of Appeals for the circuit in which the adverse employment action took place. Alternatively, if DOL fails to issue a final decision

within 180 days of the filing of the complaint, the employee has the choice of removing the action to a U.S. District Court.

DUE DILIGENCE FOR PLAINTIFFS • Since SOX was enacted on July 30, 2002, a flurry of decisions by the DOL and the federal courts have interpreted this statute. *See* www.oalj.dol.gov. As a result, attorneys taking SOX cases need to do increasing due diligence. More and more, these decisions are narrowing the scope of protection for corporate whistleblowers under the law, in ways that were unanticipated by the drafters and arguably contradict the plain language of the statute. This article looks at the current state of the law on the major elements of a SOX claim, and attempts to pinpoint the areas where the case law is developing.

1. Is The Employer Covered?

SOX only covers companies that are required to register with the U.S. Securities and Exchange Commission under section 12 of the Securities Exchange Act of 1934 ("1934 Act") or are required to file reports under section 15(d) of the 1934 Act, which essentially covers publicly traded corporations, "or any officer, employee, contractor, subcontractor, or agent of such company." The DOL ARB and the individual ALJ have found, in some circumstances, that employees of a privately owned subsidiary of a publicly traded company may also be able to bring SOX claims. *Klopfenstein v. PCC Flow Technologies Holdings Inc.*, 2004-SOX-11 (ARB May 31, 2006). To do so, an employee may be required to name both the parent and the subsidiary as parties, to show that the subsidiary acted as an agent of the publicly traded parent company, or to show that the parent had some involvement with the challenged employment action. The Solicitor of Labor has recommended to the ARB that they adopt the integrated employer test, also known as the "single employer" test, to determine coverage of subsidiaries of publicly traded companies. Under this test, an ALJ would assess:

- The interrelation of operations;
- Centralized control of labor or employment decisions;
- Common management; and
- Common ownership or financial control.

The plaintiff's attorney should anticipate this issue by determining whether facts can be pled showing a basis for holding the parent corporation liable for retaliatory acts taken against an employee of the subsidiary. SOX also provides for individual liability, so it is important to consider at the outset whether to name as a defendant or respondent the individual manager or supervisor who retaliated against the employee.

2. What Activity Is Protected?

SOX expressly protects four discrete categories of conduct by the employee: "to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of [1] section 1341, 1343, 1344, or 1348 [of Title 18], [2] any rule or regulation of the Securities and Exchange Commission, or [3] any provision of Federal law relating to fraud against shareholders," or [4] to participate in any proceeding filed or to be filed relating to an alleged violation of the foregoing. 18 U.S.C. §1514A.

Such disclosures are protected when they are made to:

- A federal regulatory or law enforcement agency;
- Any member of Congress or any committee of Congress;
- A person with supervisory authority over the employee; or
- Such other person working for the employer who has the authority to investigate, discover, or terminate misconduct.

Keep The Categories Separate

Despite the broad coverage of protected activity, some DOL ALJs have attempted to narrow the statutory coverage by importing or telescoping the third category of protected activity into the second category. Hence, some ALJs have held that reporting violations of SEC rules or regulations is insufficient, unless the employee's report also implicated fraud on shareholders. *See, e.g., Marshall v. Northrop Grumman,* 2005-SOX-8 (ALJ June 22, 2005) *Wengender v. Robert Half, Int'l Inc.,* 2005-SOX-59 (ALJ Mar. 30, 2006), and *Bishop v. Potash Corporation,* 2005-SOX-110 (ALJ Dec. 5, 2005). Fortunately, the ARB has clarified that disclosures to management about deficient internal controls fell within the zone of protected conduct, thereby rejecting ALJ decisions that limit protected conduct to allegations of actual fraud. *See Klopfenstein,* supra. In addition, several federal judges have held, consistent with the plain meaning of SOX, that disclosures to management about a violation of any SEC rules are protected, regardless of whether the violation pertains to shareholder fraud. See, *e.g.*, *Smith v. Corning Inc.*, No. 06-6516-CJS, 2007 WL 2020063 (W.D.N.Y. July 9, 2007). Employees will need to argue that the four categories of protected conduct are discrete, and cannot be conflated.

Materiality

If an employee's protected conduct is premised on a violation of SEC Rule 10b-5, 17 C.F.R. §240.10b-5, which prohibits material misrepresentations to shareholders, then the employee should be prepared to prove that the fraud was material, even though the words of the statute itself do not include a "materiality" requirement or incorporate the preamble's language. In *Platone v. FLYi*, ARB No. 04-154, ALJ 2003-SOX-27 (ARB Sept. 29, 2006), the ARB held that the manager of labor relations at a regional airline could not state a SOX claim because the evidence at the hearing indicated that the fraud was only about $1,500, and, therefore, not material. Similarly, an ALJ held, in *Wengender,* supra, that an alleged fraud of $12,500 was immaterial when the corporation reported its comments on the financial statements that were rounded off to the nearest million dollars. As SOX protects disclosures about what an employee reasonably believes constitutes a violation of "any rule or regulation of the Securities and Exchange Commission," including rules designed to prevent fraud from occurring, there are many categories of protected conduct that do not require a showing of materiality.

Reasonable Belief

The statute also requires that the "employee reasonably believe" that the corporation's conduct was illegal. For example, in *Livingston v. Wyeth, Inc.*, 2006 WL 2129794, at *10 (M.D.N.C. July 28, 2006), a district court dismissed the SOX claims of a manager at a pharmaceutical company, because the manager could not show that he had an "objectively reasonable belief, considering the employee's experience and knowledge, that the corporation is about to commit wrongdoing."

As described in *Jayaraj v. Pro-Pharmaceuticals, Inc.,* 2003-SOX-32 (ALJ Feb. 11, 2005), a complainant in a SOX action need not demonstrate that he provided information to management about an actual violation of securities law, "but only that she reasonably believed that the employer violated one of the enumerated statutes or regulations; a belief that an activity was illegal may be reasonable even when subsequent investigation reveals a complainant was wrong." The employee's "reasonable belief" that the employer violated a SEC rule or regulation "must be scrutinized under both subjective and objective standards, i.e., he must have actually believed the employer was in violation of the relevant laws or regulations and that the belief must be reasonable." *Grant v. Dominion East Ohio Gas,* 2004-SOX-63 (ALJ Mar. 10, 2005). Reasonableness is "determined on the basis of the knowledge available to a reasonable person in the circumstances

with the employee's training and experience." *Id.* However, as section 806 "is a prophylactic federal law aimed at preventing fraud against shareholders," *Harvey v. Safeway, Inc.*, 2004-SOX-21 at 30 (ALJ Feb. 11, 2005), the complainant need not demonstrate that he reported an actual violation of securities law, since "to find otherwise would require that a whistleblower allow the violation to occur before reporting it. This would defeat the intent of the Act and whistleblower law in general, which is to prevent the carrying out of the underlying crime." *Getman v. Southwest Securities, Inc.*, 2003-SOX-8, at 20 n.8 (ALJ Feb. 2, 2004), *reversed on other grounds*, 2005 WL 4888992 (ARB July 29, 2005).

A recent ARB decision underscores the importance of assessing the objective reasonableness of a complainant's protected disclosure. *See Welch v. Cardinal Bankshares Corp.*, ARB No. 05-064, ALJ No. 2003-SOX-15 (ARB May 31, 2007). As a result of this decision, expert witness testimony may become more important in SOX cases. In addition, attorneys assessing potential SOX claims will need to carefully analyze the securities rules implicated by a complainant's protected disclosures.

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Specificity

Some ALJs have required that the employee provide specific details about the alleged illegal conduct, and not generalized accusations that the corporation engaged in illegalities. While the employee need not invoke specific statutory provisions in his reports, the employee should provide sufficient details to place the employer on notice.

Violations Of Internal Policies Not Covered

The ARB and an ALJ have also held (*Reddy v. Medquist, Inc.*, 2004-SOX-35 (ARB Sept. 30, 2005); *Marshall*, supra), that SOX does not protect reports or complaints about violations of internal policies and procedures (such as accounting procedures), when those violations do not implicate the federal statutes, regulations, and rules. However, if those internal accounting procedures were established comply with SOX mandates or SEC regulations, then the company's failure to comply with those accounting procedures could be a violation of a securities law or regulation, so that reports would be protected under SOX. *Morefield v. Exelon Services, Inc.*, 2004-SOX-2 (ALJ Jan. 28, 2004). For example, an employee's complaint that a transaction is not in accordance with management's criteria is arguably protected in that it implicates the books and records and internal control provisions of Section 13 of the Securities Exchange Act of 1934.

SOX Does Not Exclude "Duty Speech" Claims

The U.S. Supreme Court's May 2006 decision in *Garcetti v. Ceballos*, 126 S. Ct. 1951 (2006), held that state and local government employees could not bring First Amendment whistleblower retaliation claims based on their work-related speech, if that speech was part of their job duty. Some employers have attempted to argue that *Garcetti* prohibits SOX claims based on job duty speech. However, *Garcetti's* "duty speech" limitation has no bearing on SOX claims, since SOX creates a specific statutory scheme, without any limitation on whether the employee's reports were within the scope of his job duties. Moreover, there is a long line of DOL decisions under analogous whistleblower protection statutes in which the Secretary of Labor and the ARB rejected the *Garcetti* "duty speech" doctrine. For example, DOL has held that quality control personnel at nuclear plants, whose primary job responsibility is to identify and report regulatory or procedural nonconformances, engage in protected conduct when they report such

problems. *See, e.g., Jopson v. Omega Nuclear Diagnostics,* 93-ERA-54, at 3 (Sec'y Aug. 21, 1995) ("To the extent that the ALJ's analysis suggests that reporting safety violations in the course of one's regular duties does not constitute protected activity under the ERA, this conclusion is rejected"); *Collins v. Florida Power Corp.,* 91-ERA-47 and 49 (Sec'y May 15, 1995) (a quality assurance specialist's participation in a surveillance to identify instruments that were incorrectly calibrated is protected activity under the whistleblower protection provision of the Energy Reorganization Act). Similarly, the DOL ARB held that an environmental inspector whose primary job responsibility was to monitor respondent's compliance with the Safe Drinking Water Act, engaged in protected activity by reporting noncompliance to the EPA. *White v. The Osage Tribal Council,* 95-SDW-1 (ARB Aug. 8, 1997). In a recent decision, an ALJ rejected the employer's attempt to apply the "duty speech" doctrine to SOX. *See Deremer v. Gulfmark Offshore Inc.*, 2006-SOX-2 (ALJ June 29, 2007). The ALJ noted that the legislative history of SOX clearly indicates that it was intended to cover disclosures made in the course of an employee performing her ordinary job responsibilities.

Under SOX, employees need only demonstrate by a preponderance of the evidence that their protected conduct was a "contributing factor" in the employer's retaliatory activity.

3. What Is The Causation Standard?

Under SOX, employees need only demonstrate by a preponderance of the evidence that their protected conduct was a "contributing factor" in the employer's retaliatory activity. In *Klopfenstein,* supra, the ARB rejected the ALJ's attempt to impose a higher standard, such as "the motivation." The ARB explained that a contributing factor is "any factor, which alone or in combination with other factors, tends to affect in any way the outcome of the decision," and this standard does not "require a whistleblower to prove that his protected conduct was a 'significant,' 'motivating,' 'substantial,' or 'predominant' factor in a personnel action in order to overturn that action." Once the employee meets this burden, the employee will prevail unless the employer demonstrates by "clear and convincing" evidence that it "would have taken the same unfavorable personnel action in the absence of the complainant's protected behavior or conduct." 29 C.F.R. §1980.104(c).

4. What Remedies And Damages Are Available?

SOX provides for fairly broad statutory damages. The prevailing employee "shall be entitled to all relief necessary to make the employee whole." This relief may include reinstatement; back pay with interest; and compensation for special damages, "including litigation costs, expert witness fees, and reasonable attorney fees." "Special damages" has been interpreted to include emotional distress damages. *See, e.g., Kalkunte v. DVI Financial Servs. Inc.*, 2004-SOX-56 (ALJ July 18, 2005).

There is currently a controversy over the reinstatement remedy, with employers attempting to argue that reinstatement should be put on hold pending resolution of all appeals. Two federal court decisions (*Bechtel v. Competitive Technologies, Inc.,* 448 F.3d 469 (2d Cir. 2006) and *Welch v. Cardinal Bankshares Corp.,* 454 F. Supp. 2d 552 (W.D. Va. 2006)) have held that they lack jurisdiction to enforce reinstatement orders when the employer refused to reinstate the successful employee, on the ground that a reinstatement order issued by OSHA or an ALJ is only a "preliminary" ruling, pending resolution of the appeal on the merits.

5. Should You Go To The Federal District Court?

SOX provides employees with the opportunity to terminate the DOL proceeding if DOL has not issued a final decision within 180 days of filing the complaint, and to initiate an action for de novo review in the U.S. district courts. 18 U.S.C. §1514A(b)(1)(B). The employee's attorney needs to carefully consider the advantages and disadvantages of proceeding in federal district court as opposed to remaining within DOL. One key difference is the right to a jury trial in the federal courts, since an ALJ's evidentiary hearing is comparable to a bench trial. However, some federal courts have held that a SOX plaintiff does not get a jury trial, on the grounds that SOX provides only equitable relief (pecuniary damages), not legal relief (punitive and non-pecuniary damages). *Murray v. TXU Corp.*, No. 3:03-CV-0888-P, 2005 WL 1356444, at *2-*4 (N.D. Tex. June 7, 2005).

Another potential advantage of proceeding in federal court is that discovery, including third-party discovery, can be much broader in federal court proceedings, since while ALJs can issue subpoenas to third parties, they lack the authority to enforce those subpoenas. *Childers v. Carolina Power & Light Co.*, ARB 98-077, ALJ 1997-ERA-32 (ARB Dec. 29, 2000).

Several recent federal court decisions indicate that federal judges are more inclined to construe SOX broadly than the DOL's ARB. For example, while the ARB erroneously concluded in *Welch v. Cardinal Bankshares Corp.*, ARB No. 05-064, ALJ No. 2003-SOX-15 (ARB May 31, 2007), that a disclosure about a violation of generally accepted accounting practices cannot constitute protected conduct, a conclusion they reached without reference to any of the governing SEC rules, a federal judge held that such a disclosure is protected under SOX. *Smith*, 2007 WL 2020063 at *5; *see also Mahony v. Keyspan Corp.*, No. 04-CV-554 SJ, 2007 WL 805813 at *6 (E.D.N.Y. Mar. 12, 2007) (holding that summary judgment should be denied when "a fair and reasonable juror could find that Plaintiff reasonably believed that the company was engaging in accounting practices that needed to be corrected before its financial statements misled shareholders"). In *Smith*, the judge specifically consulted and applied the governing SEC rules to determine whether the complainant's disclosures were protected.

Similarly, while the ARB judicially narrowed SOX by holding that a disclosure about mail fraud or wire fraud is protected only when "the alleged fraudulent conduct must at least be of the type that would be adverse to investor's interests," *Platone*, ARB No. 04-154 at 15, a federal judge, relying on the statutory text, instead held that SOX "clearly protects an employee against retaliation based upon that employee's reporting of mail fraud or wire fraud regardless of whether that fraud involves a shareholder of the company." *Reyna v. Conagra Foods, Inc.*, No. 3:04-CV-39 CDL, 2007 WL 1704577, at *15 (M.D. Ga. June 11, 2007).

6. What Issues Should Be Considered In Settlement?

SOX has a very short statute of limitations—90 days after the date on which the retaliatory act(s) occur. There is also no statutory provision for tolling of the statute of limitations, although employees may be able to make equitable tolling or equitable estoppel arguments. The complaint is automatically filed with the SEC, 29 C.F.R. §1980.104(a), unless the employee submits an affidavit requesting that DOL keep the complaint confidential, which may be of great significance for the employer who would not want the SEC to initiate an enforcement investigation.

Thus, to settle a SOX claim without initiating litigation, the employee's counsel has a very short time period to do so, and may have to file the complaint before settlement discussions can be completed.

Also, any attempt to settle the case down the road may be impeded by a plaintiff's failure to identify all possible claims and corporate parties in his or her DOL complaint, as DOL may find that claims not identified within the 90-day statute of limitations period are waived.

7. Special Issues Involving In-House Attorneys As Whistleblowers

Attorneys, including in-house counsel, are generally required under the Rules of Professional Conduct to maintain as confidential all attorney-client communications, absent circumstances such as the client's intent to use the attorney's services in furtherance of crime, or the client's stated intent to commit a serious crime. Since securities fraud and related conduct that is covered under SOX may not rise to the level of crimes that have to be disclosed under the state ethical rules, the SEC has promulgated regulations, 17 C.F.R. Part 205, that require an attorney to report suspected violations "up the chain" in the corporation, and then allow the attorney to report those violations to the SEC if the internal reports do not resolve the violations.

Because of this requirement for in-house attorneys to report corporate fraud, in-house attorneys can generally avail themselves of SOX's protection, and use privileged information as necessary to prove their claims. State bar ethics opinions and court decisions that have addressed this issue have increasingly recognized that in-house attorneys do not violate the attorney-client privilege by reporting corporate fraud and misconduct. *Willy v. Admin. Review Bd.*, 423 F.3d 483 (5th Cir. 2005); *Kalkunte v. DVI Financial Services, Inc.*, 2004-SOX-56 (ALJ July 18, 2005); ABA Rules of Professional Conduct, Rule 1.6(b)(6) (attorney may disclose privileged information "to comply with other law," which would include SOX reporting obligations); N.C. Formal Ethics Opinion 2005-9 (Jan. 20, 2006) (lawyer may report confidential information as permitted by SEC regulations). Hence, in-house counsel are likely to become an increasing source of SOX claims, given that they are among those most likely to uncover corporate fraud and other violations of SEC rules and regulations.

CONCLUSION • Over the last five years, many practitioners have wondered exactly how to craft whistleblower claims under SOX. As the law has developed, much of the guesswork has been eliminated. But there is still quite a bit of room to refine some of the thornier points, and it will be up to the practitioners who bring these claims to see to it that the preventive and remedial purposes of SOX are carried out in the tribunals.

PRACTICE CHECKLIST FOR
Seven Questions For Sarbanes-Oxley Whistleblowers To Ask

- Is the employer covered? SOX only covers companies that are required to register with the U.S. Securities and Exchange Commission, which essentially covers publicly traded corporations, "or any officer, employee, contractor, subcontractor, or agent of such company." In some circumstances, employees of a privately owned subsidiary of a publicly traded company may also be able to bring SOX claims.

- What activity is protected? SOX expressly protects four discrete categories of conduct by the employee: "to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of [1] section 1341, 1343, 1344, or 1348 [of Title 18], [2] any rule or regulation of the Securities and Exchange Commission, or [3] any provision of Federal law relating to fraud against shareholders," or [4] to participate in any proceeding filed or to be filed relating to an alleged violation of the foregoing. 18 U.S.C. §1514A.

- What is the causation standard? Under SOX, employees need only demonstrate by a preponderance of the evidence that their protected conduct was a "contributing factor" in the employer's retaliatory activity.

- What remedies and damages are available? SOX provides for fairly broad statutory damages. The prevailing employee "shall be entitled to all relief necessary to make the employee whole."

- Should you go to the federal district court? SOX provides employees with the opportunity to terminate the DOL proceeding if DOL has not issued a final decision within 180 days of filing the complaint, and to initiate an action for de novo review in the U.S. district courts. 18 U.S.C. §1514A(b)(1)(B). One key difference is the right to a jury trial in the federal courts and broader discovery.

- What issues should be considered in settlement? SOX has a very short statute of limitations—90 days after the date on which the retaliatory act(s) occur. Thus, to settle a SOX claim without initiating litigation, the employee's counsel has a very short time period to do so, and may have to file the complaint before settlement discussions can be completed.

- Are there special issues involving in-house attorneys as whistleblowers? The SEC has promulgated regulations, 17 C.F.R. Part 205, that require an attorney to report suspected violations "up the chain" in the corporation, and then allow the attorney to report those violations to the SEC if the internal reports do not resolve the violations.