

New York Law Journal



Web address: <http://www.law.com/ny>

VOLUME 229—NO. 122

THURSDAY, JUNE 26, 2003

MERGERS AND ACQUISITIONS

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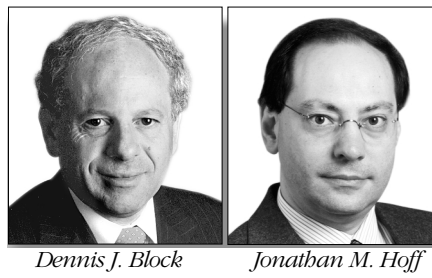
Whistleblower Protection Under The Sarbanes-Oxley Act

The Sarbanes-Oxley Act's general goal of enhancing corporate accountability and transparency is by now familiar to most corporate attorneys, as is the act's accompanying enhancement of penalties. Underreported, however, has been the statute's protection of corporate "whistleblowers" — those who report irregularities or misconduct to higher authority. Yet that protection is a significant aspect of the act, as whistleblowers were significant players according to accounts of the recent corporate scandals that prompted the adoption of Sarbanes-Oxley.

In this context, the term "whistleblower" has been used to include employees whose disclosures of corporate irregularities were made internally to management or the board, even if the employees did not contact relevant authorities in government.¹ Corporate counsel should take note of the new federal regulatory scheme, because it carries profound consequences for the corporation that does not develop appropriate internal controls and ethical frameworks.

Background

Before the enactment of Sarbanes-Oxley, state law determined the extent of protection enjoyed by whistleblowers in the private sector. Those who were



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employed "at will," with no additional contractual protection, could face a wide range of employer responses to any decision by the employees to expose misconduct.² A cause of action for retaliatory discharge now exists in at least 42 states, though such protection, at times, has been limited.³ For instance, New York's whistleblower protection under §740 of the Labor Law "is limited to an employee who discloses or threatens to disclose an employer activity or practice that (1) is in violation of a law, rule or regulation, and (2) creates a substantial and specific danger to the public health." Fiscal improprieties within a company do not fall into either category.⁴ Preexisting federal law had included criminal prohibition of violent retaliation against a witness or informant,⁵ but Sarbanes-Oxley added new civil as well as criminal provisions that address economic retaliation.

Civil Liability

A new civil cause of action is established in §806 of Sarbanes-Oxley, which protects employees of publicly traded companies who lawfully provide

evidence or otherwise assist in the investigation of conduct that the employee "reasonably believes constitutes" violations of the federal mail, wire, bank, or securities fraud statutes,⁶ "any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders."

The employee is protected if his or her information or assistance is being provided to (1) "a Federal regulatory or law enforcement agency"; (2) any member or committee of Congress; or (3) anyone "with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct)."⁷ Also protected are employees who "file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation."⁸

In such cases, a cause of action arises against not only a company itself, but also any employees, officers, contractors, subcontractors, and agents who "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee" who has engaged in the protected activity.⁹ Thus, the civil liability provisions of Sarbanes-Oxley cover a broad range of retaliatory measures that can be taken against an employee whether or not the underlying reporting is directed internally within the corporate organization or toward relevant government authorities. Such activity, however, must relate to the enu-

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merated types of fraud. The range within which an employee's belief is held to constitute a "reasonable belief" that conduct amounts to a violation is bound to be an important question as courts determine the scope of §806.

The employee claimant who prevails under this section is entitled to "all relief necessary to make the employee whole," including full reinstatement with the same seniority status, back pay with interest, and "any special damages sustained as a result of the discrimination, including litigation costs, expert witness fees, and reasonable attorney fees."¹⁰ In addition to these damages, the statute allows the employee to seek any other relief to which he or she otherwise may be entitled under federal or state law or collective bargaining agreements.¹¹

To obtain relief, an employee must file a complaint with the Secretary of Labor within 90 days of the violation.¹² If the Secretary has not issued a final decision within 180 days of the filing of the complaint, then the claimant (absent a showing of his or her bad faith) may bring the claim for *de novo* review in federal district court.¹³ A §806 claim is governed by the rules and procedures of 49 U.S.C. §42121(b), a whistleblower protection statute that applies to airline employees who provide information concerning violations of Federal Aviation Administration regulations or other federal air safety provisions.¹⁴ As provided by §42121(b), the person named in the complaint will have an opportunity to submit a response, as well as witness statements. The Secretary then "shall conduct an investigation and determine whether there is reasonable cause to believe that the complaint has merit." The Secretary will issue findings or a preliminary order, accordingly, which, in turn, may be followed by objections or a hearing on the record, if requested. Absent such a request, the preliminary order is deemed final after 30 days.¹⁵

The Secretary will dismiss the complaint rather than proceed with an investigation where a claimant fails to make a *prima facie* showing that the whistleblowing was a

"contributing factor" in any unfavorable personnel action. Moreover, the Secretary shall not go forward with the investigation where the "employer demonstrates, by clear and convincing evidence, that the employer would have taken the same unfavorable personnel action in the absence of that behavior."¹⁶ The Secretary's determination may be reviewed on appeal to the Court of Appeals, subject to the standard of judicial review set forth in the Administrative Procedure Act.¹⁷

Section 1107 of Sarbanes-Oxley establishes criminal liability for whistleblower retaliation that is in some ways more limited and in others broader than the corresponding civil liability provisions. This provision expands the criminal code's proscription of violence against witnesses and informants to a wide range of economic retaliation. Thus, anyone who, "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 to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense," is subject to penalties that may include fines and/or imprisonment for up to 10 years.¹⁸

By defining the victim only as one who provides "truthful information" to a law enforcement officer, §1107 addresses itself to a narrower category of whistleblower than §806, which protects those who provide information or investigative assistance to appropriate officials within a corporate organization or within any federal regulatory or congressional body. At the same time, the criminal provision is broader in that it addresses whistleblowing where the underlying violation or possible violation is not confined to enumerated federal offenses, but may in fact include "any Federal offense." Although the civil provision specifies a list of retaliatory activities covered, §1107 prohibits any intentional retaliation, "including interference with the lawful employment or livelihood of any person." The relationship between those who are protected and the offender is not

specified. Moreover, the prohibition is not intended to be limited to American companies or domestic activity, as the criminal provision states that "[t]here is extraterritorial Federal jurisdiction over an offense under this section."¹⁹

The regulatory scheme of Sarbanes-Oxley's whistleblower protection provisions clearly presents serious issues for any publicly traded company and its personnel on every level. The act reflects a public policy that, in one court's words, allows "even current employees to assist in securities fraud investigations."²⁰ Expectations of employee loyalty toward the corporate hierarchy naturally will tend to increase deference to the chain of command and obligations to maintain confidentiality, but corporate managers are cautioned to resist the temptation to allow such constraints to stifle disclosures of irregularities.²¹ By inculcating a corporate culture of law compliance and dedication to the paramount interests of shareholders, a company can avoid such pitfalls. For guidance in preventing liability, a company should look both to applicable regulations and to practical measures that enhance communication and openness throughout the corporate chain of command.

Audit Committees

One important regulation can be found in §301 of Sarbanes-Oxley, which requires publicly traded companies to establish audit committees consisting of independent directors. Each audit committee, in turn, is required to establish procedures for "the receipt, retention, and treatment of complaints" the company receives "regarding accounting, internal accounting controls, or auditing matters," as well as "the confidential, anonymous submission by employees ... of concerns regarding questionable accounting or auditing matters."²² Thus, the audit committee can play an essential role in providing an outlet for prospective whistleblowers (even those reporting matters unrelated to financial and auditing issues) to be heard and treated fairly.

Anonymity, for that matter, should be available wherever practicable to internal complainants who might otherwise feel chilled in their communication of issues of potential wrongdoing.

More broadly, successful compliance depends on a company's adherence to a code of ethics. Such a code is a benchmark of a company's commitment to a culture of compliance. It establishes the standard for law and regulatory compliance and internal reporting procedures regarding conflicts of interest, as well as other conditions not conducive to compliance. Sarbanes-Oxley requires public disclosure of codes of ethics for senior financial officers and any waivers of the codes,²³ but it is advisable to establish such a code for employees at every level. Management should act beyond what is minimally required to inculcate respect for the spirit as well as the letter of the law in personnel at every level from the start of their employment. Because the whistleblower protection statute covers an employee's reasonable belief that certain conduct constitutes business fraud, employees should be instructed at the outset as to conduct that is and is not prohibited.

A company should also consider the designation of an appropriate person to assume the task of instructing employees accordingly and to receive complaints. Ultimately, this individual's role must include ensuring the audit committee's compliance with §301 of Sarbanes-Oxley. It may be preferable to appoint an in-house attorney to serve this function for several reasons, not the least of which reside in the obligations to which attorneys are already subjected. Under §307 of Sarbanes-Oxley and accompanying SEC regulations, attorneys representing a company are required to report material violations of the securities laws or breaches in fiduciary duty to the company's chief legal officer, chief executive officer (or equivalent), or a qualified legal compliance committee. Unless those officials respond appropriately, the attorney must report "up the ladder" to the audit committee (or other qualified

committee), or to the full board of directors.

Moreover, the rules allow the attorney to reveal confidential information to the Securities and Exchange Commission in order to prevent or remedy material violations that threaten substantial injury to the financial interest or property of the company or its investors.²⁴ In this way, the regulatory scheme established by Sarbanes-Oxley mandates a channel for disclosure of legal violations that a company should utilize and make accessible to its employees.

The issues confronted by public companies in responding to allegations by prospective whistleblowers are by nature conducive to assessment by legal professionals. Whether instructing personnel or receiving complaints, the task of measuring the legal consequences of hypothetical or real instances of conduct observed in the workplace can be a complex one. An employee may observe conduct that resembles but does not quite constitute a form of securities fraud, yet whistleblower protection — and thus potential liability — will still attach where the employee's belief in the occurrence of a violation is reasonable. The analysis may not be intuitive, and attorneys are better equipped than other managers to determine such issues, which are likely destined to be defined more precisely by judicial decision that will have the benefit of hindsight.

Whether or not a company decides to utilize its attorneys or designate other personnel to take employee complaints to the audit committee and/or senior management, the whistleblower protection provisions of Sarbanes-Oxley can be followed only through measures that earnestly open channels to employees. To rely on immediate supervisors not to retaliate against their subordinates may be viewed as insufficient, no matter how stern the warning against retaliation, when an underlying problem may reflect negatively on someone up the supervisory chain of command. In too many cases, human nature and self-interest, if unchecked, can override official advice to protect the best interests of a publicly traded company and its

shareholders. Additionally, Sarbanes-Oxley's policy of allowing employees to assist in securities fraud investigations does not anticipate being thwarted by overly rigid applications of the chain of command and overbroad confidentiality constraints. A company is well advised to incorporate this policy explicitly into its culture, and to utilize its attorneys and audit committee to assist it in addressing employee complaints. Success in maintaining workable channels for assessing and addressing suspect behavior within the corporation may well prove the difference between preventing wrongdoing and paying the penalty for it.



(1) Two of the most prominent examples, Sherron Watkins of Enron and Cynthia Cooper of WorldCom, were designated two of Time magazine's three "persons of the year" in 2002 for their roles as whistleblowers in the notorious scandals that befell their respective corporations. Richard Lacayo and Amanda Ripley, "Persons of the Year," Time, Dec. 30, 2002, at 30. But see Dan Akman, "Whistleblower?," Wall Street Journal, Dec. 24, 2002, at A10 (questioning the designation of Watkins as a whistleblower).

(2) Leonard M. Baynes, "Just Pucker and Blow?: An Analysis of Corporate Whistleblowers, the Duty of Care, the Duty of Loyalty, and the Sarbanes-Oxley Act," 76 Saint John's Law Review 875 (2002).

(3) See *id.*; David M. Brodsky and Blair G. Connelly, "New Whistleblower Protection Liability Under the Sarbanes-Oxley Act," The Corporate Governance Advisor, at 26-27 (January/February 2003) (discussing limited protection offered in New York).

(4) *Lamagna v. New York State Association for Help of Retarded Children Inc.*, 158 A.D.2d 588, 589, 551 N.Y.S.2d 556 (2d Dep't 1990).

(5) See 18 U.S.C. §1513.

(6) See 18 U.S.C. §§1341 (mail fraud), 1343 (wire fraud), 1344 (bank fraud), 1348 (securities fraud).

(7) 18 U.S.C. §1514A(a).

(8) 18 U.S.C. §1514A(a)(2).

(9) 18 U.S.C. §1514A(a).

(10) 18 U.S.C. §1514A(c).

(11) 18 U.S.C. §1514A(d).

(12) 18 U.S.C. §1514A(b).

(13) 18 U.S.C. §1514A(b)(1)(B).

(14) 18 U.S.C. §1514A(b)(2).

(15) 49 U.S.C. §42121(b)(2)(A).

(16) 49 U.S.C. §42121(b)(2)(B).

(17) 49 U.S.C. §42121(b)(4)(A).

(18) 18 U.S.C. §1513(e).

(19) 18 U.S.C. §1513(d).

(20) *In re JDS Uniphase Corp. Sec. Litig.*, 238 F. Supp. 2d 1127, 1136 (N.D. Cal. 2002).

(21) See *id.* (the act "does not establish a public policy in favor of allowing employers to muzzle their employees with overbroad confidentiality agreements").

(22) 15 U.S.C. §78j-1(m)(4).

(23) 15 U.S.C. §7264.

(24) 15 U.S.C. §7245; 17 C.F.R. §205.3.

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