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Whistleblower Protections and the Sarbanes-Oxley Act

Administrative law judge decisions apply provision to broad range of conduct

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As we approach the third anniversary of the enactment of the Sarbanes-Oxley Act of 2002 (SOX), companies, as employers, are perhaps most concerned with SOX's "whistleblower" provisions. There have now been a significant number of decisions from the Department of Labor's administrative law judges (ALJs) on those issues. Based on these decisions, SOX may reach a broader range of conduct and provide a more potent array of remedies than most employers had anticipated.

While SOX addresses a wide range of matters — from conflicts of interests affecting securities analysts to significantly enhanced criminal penalties for mail fraud, wire fraud and violations of the Employee Retirement Income Security Act (ERISA) — it is Section 806 of the Corporate and Criminal Fraud Accountability Act that may be most significant from the employment relations perspective. That section creates a civil right of action that protects employees of covered companies from retaliation resulting from reporting any conduct that the employee "reasonably believes constitutes" a violation of federal criminal statutes proscribing mail, wire, bank or securities fraud, any rule or regulation of the Securities and Exchange Commission (SEC) or "any provision of Federal law relating to fraud against shareholders . . . ."[1]

Protection under this section of SOX is triggered when an employee directly or indirectly provides information or assistance to a federal regulatory or law enforcement agency, Congress, or to a supervisor within the company or someone with "the authority to investigate, discover, or terminate misconduct."[2] Because SOX requires that "whistleblowers" first file administrative complaints with the Department of Labor, the decisions of its ALJs provide the first signals of how SOX will be construed.

'Securities Fraud'

A number of ALJ decisions have considered the question of how direct the connection must be between the allegations raised by the purported whistleblower and what many would instinctively regard as "securities fraud." Especially significant in this regard is *Morefield v. Exelon Services, Inc.*[3] There, the complainant, the former vice president of finance for a corporate subsidiary, alleged that he had been threatened, intimidated and, ultimately, terminated from his employment after he reported that top management of the subsidiary intentionally manipulated internal financial results, forecasts and accounting records to make the company's financial performance appear better than it actually was. Though the complaint had been dismissed at the administrative level, the ALJ reinstated it.

In seeking dismissal, the company contended, first, that no violation of any applicable securities rule or law had been stated because external reports were not affected by the alleged internal overstatement of revenues and, second, that since the overstatement of approximately $2 million amounted to less than 1/10,000 of 1 percent of the ultimate parent's revenues, there was no reasonable basis for believing that it was material.

The ALJ rejected both arguments, contending as to the first that because SOX whistleblower protection extends to "any federal law broadly relating to fraud against shareholders," it encompassed alleged violations "of accounting rules and the adequacy of internal accounting controls" for covered companies. As to the second argument, the judge concluded that because SOX "places no minimum dollar value on the protected activity it covers" and is "largely a prophylactic" measure, SOX whistle-blowing protection applied even for "seemingly paltry sums" and irrespective of whether materiality was an element of the predicate SOX-required frauds.

There are other ALJ decisions that seem to deny SOX protection to complaints about "internal company policy as opposed to actual violations of federal law"[4] or where it is only "speculative" that potential investors would be misled.[5] But *Morefield* nonetheless looms as a foreboding omnipresence to employers who were hoping for a restrictive interpretation.

In *Hendrix v. American Airlines, Inc.*, the scope of SOX was extended even further to what most employers would view as "garden variety" employee theft.[6] There, the complainant alleged retaliation for participating in an investigation of a co-worker who had been accused of creating sculptures during his work time out of the company's spare parts for its aircraft. Because the sculpting machinist violated Federal Aviation Administration (FAA) and company procedures for tagging and disposing of scrap aircraft parts, the employee was protected by the federal aviation whistleblower statute. Rejecting (as in *Morefield*) the administrator's dismissal of the complaint, the ALJ concluded that the whistleblower was also protected by SOX because he reasonably believed that the co-worker "was committing fraud against [the airline] and its shareholders by creating art objects for personal gain out of company material, on company time."

While the conduct was undoubtedly dishonest and, perhaps, even deceptive, the ALJ never explained how it was fraudulent, let alone one of the predicate frauds required for SOX whistleblower protection except to say that the sculpting machinist "undoubtedly used the mail or wires as part of his sculpture business," and thus his fraudulent activity is of a kind proscribed by federal law.

Another decision affording protection to matters seemingly far removed from the principal concerns of SOX was *Platone v. Atlantic Coast Airlines Holdings, Inc*.[7] There, the former manager of labor relations for the respondent airline reported her "suspicions" that members of management were allowing certain pilots to abuse payroll rules that, in effect, overcompensated them for absences from work for attending to union business and that, since the pilots were union officials responsible for collective bargaining, this was part of a scheme to "improperly channel money to senior members of [the pilots' union] . . . in order to convince these union officials to make contract concessions that would favorably affect [the airline's] bottom line." The ALJ concluded that the complainant's reports of this "scheme" qualified as protected activity under SOX because "[s]uch a scheme, by its very nature, would involve the use of the mail and wires, and could constitute fraud of the [airline's] shareholders."

Apparently, no one pointed out to the ALJ that payoffs to union leaders for sweetheart labor contracts is already a crime under federal labor law,[8] but not one of the "frauds" enumerated by SOX. To be protected by SOX, the whistleblower must reasonably believe that the reported conduct violated one of several specifically enumerated federal fraud statutes, an SEC rule or regulation or — and this is the "catchall" clause — a provision of federal law "relating to fraud against shareholders." Payoffs to union leaders — which presumably were intended to produce more savings to the company's labor costs than the amount of the bribe — would undermine free collective bargaining. It could be conceived of as fraud by the union leaders "against the union members," and clearly violates a federal law "relating to" labor-management relations, but it is rather hard to see how this could be a violation of a federal law "relating to fraud against shareholders." And, if it were, then it would seem that reporting violations of virtually any federal law — from bribing foreign officials to criminal violations of federal environmental protection statutes — could be protected activity under SOX.

Such considerations may have been on the mind of the ALJ in *Hopkins v. ATK Tactical Systems*, which gave a more limited interpretation of the scope of SOX coverage. Brian Hopkins alleged that he was subjected to a hostile work environment and saw his employment terminated after he reported to his superiors, the Environmental Protection Agency (EPA), and the Occupational Safety and Health Administration (OSHA) that his work site had released "thousands of gallons of sludge water into the ground water system"[9] due to poor maintenance and overdue inspections.

The ALJ noted that SOX's legislative history "makes it clear that fraud is an integral element of a cause of action" and, while "fraud" for SOX whistleblower purposes was "undoubtedly broader" than the standard under SEC antifraud regulations, "an element of intentional deceit that would impact shareholders or investors is implicit." He therefore recommended dismissal because the complaint did not address "any kind of fraud" and did not involve "transactions related to securities."

Preliminary Reinstatement

One of the most significant innovations of SOX whistleblower protection, at least as compared to other federal employment laws forbidding retaliation against those engaged in protected activity, is the power of preliminary reinstatement, pursuant to which a complainant can be ordered back to work before the employer has had a hearing or a final determination of liability.

The regulations implementing Section 806 provide that if "reasonable cause" is found to believe that a violation occurred, a preliminary order can be issued that includes immediate reinstatement.[10] Unlike other elements of a preliminary order, reinstatement is not stayed by an objection or a request for a hearing. Prior to the enactment of SOX, the threat of mandatory reinstatement prior to a final decision was almost unheard of in employment law. The impact of this potential remedy is magnified by the fact that a SOX whistleblower can often be a high-ranking executive working in a sensitive position.

The interim final rule implementing SOX provided for an exception to preliminary reinstatement when the respondent "establishes that the complainant is a security risk."[11] This exception, however, is narrowly construed and applied "only in situations where the named person clearly established . . . that the reinstatement of an employee might result in physical violence against persons or property."[12]

The final rule gave some relief to employers, providing that they may petition the ALJ for a stay of the preliminary reinstatement order. If a stay is denied, and the employer can establish "to OSHA's satisfaction that reinstatement is inadvisable for some reason," the ALJ may order that, pending a final determination, the complainant receive full pay and benefits without actually returning to work. While such "economic reinstatement" can mitigate some of the potential disruption of having a terminated employee returned to work while he or she is still litigating against the company, the DOL specifically rejected the suggestion that the employer be entitled to reimbursement for the costs of such reinstatement if ultimately successful in the litigation.[13]

Perhaps even more troubling to employers is the prospect that the ALJ will not regard reinstatement as "inadvisable" even if the whistleblower is a high-ranking officer who is, under normal circumstances, expected to work closely and cooperatively with other senior executives. In *Welch v. Cardinal Bankshares Corp.*, the ALJ demonstrated a willingness to reinstate the former CFO despite marked enmity and distrust between him and others.[14] As the ALJ saw it, "although David Welch [the whistleblowing former CFO] will be required to report to a CEO and board of directors who have been openly critical of Welch since this litigation was initiated, that circumstance is not sufficiently unusual in the context of a Sarbanes-Oxley whistleblower case to warrant denying him reinstatement."

The factors weighing against reinstatement in *Welch* are more substantial: neither the SEC nor state bank regulators found impropriety in the accounting practices Welch had objected to; the employer was a small, community bank whose executives were required to work closely together; and there was not only hostility toward the whistleblower but also open criticism of errors he had made before he was fired. If actual reinstatement was not "inadvisable" in these circumstances, it is difficult to imagine when it would be.

Preliminary reinstatement is a potent weapon that can be used by unscrupulous employees to leverage a more generous severance package based on allegations that may be barely colorable under SOX. While an employer can forestall preliminary reinstatement if it is able to establish in the initial administrative investigation by "clear and convincing evidence" that there was no SOX violation,[15] this may be difficult to accomplish in all but the most frivolous cases, given the broad interpretations of SOX whistleblower protection discussed above. Employers may therefore be forced to consider a negotiated settlement favorable to the complaining employee before a preliminary order is issued whenever he or she is a senior company executive.

After nearly three years since the enactment of SOX, significant uncertainty remains with regard to issues as important as the scope of liability and remedy. It appears likely that this uncertainty will remain until the DOL's Administrative Review Board and the courts develop a body of case law more definitively construing SOX's scope.

Reddy v. Medquist, Inc.Lerbs v. Buca di Beppo, Inc.

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Endnotes

1. 18 U.S.C. §1514A(a)(1).

2. 18 U.S.C. §1514(A)(a)(1)(c).

3. 2004-SOX-00002 (ALJ Jan. 28, 2004).

4. Reddy v. Medquist, Inc., 2004-SOX-00035 (ALJ June 10, 2004).

5. Lerbs v. Buca di Beppo, Inc., 2004-SOX-00008 (ALJ June 15, 2004).

6. 2004-AIR-00010, 2004-SOX-00023 (ALJ Dec. 9, 2003).

7. 2003-SOX-00027 (ALJ April 30, 2004).

8. See Section 302 of the Labor Management Relations Act, 1947, 29 U.S.C. §186.

9. 2004-SOX-00019 (ALJ May 27, 2004).

10. 29 C.F.R. §1980.105.

11. 29 C.F.R. §1980.105(a)(1).

12. 69 Fed. Reg. at 52,109.

13. Id.

14. 2003-SOX-00015 (Feb. 15, 2003).

15. 29 C.F.R. §1980.104(b), (c).