

Corporate Sarbanes-Oxley Whistleblower Risks: Still Real, Still Hazy

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From commercial titans — Citigroup, ING, Marriott International, Anheuser-Busch and Wal-Mart, among many others — to lesser known entities such as Big Dog Holdings and Belfort Instrument Co., American enterprises large and small have become acquainted first-hand with the whistleblower protections Congress included in the Sarbanes-Oxley corporate governance reform legislation four years ago. The acquaintance was made involuntarily, of course, when these and other companies were named as respondents in whistleblower retaliation suits by former or current employees.

Although the U.S. Department of Labor (DOL) has been adjudicating whistleblower retaliation claims under environmental, transportation and other federal laws for decades, so-called SOX claims have rapidly become the most common type of whistleblower case handled by the DOL (not counting claims under the OSHA anti-retaliation provision, which does not grant employees a private cause of action).

Undoubtedly, the growth in the number of complaints filed under the whistleblower protection provision, SOX Section 806, is due in part to the fact that Section 806 is not limited in its coverage to a particular industry. The statute instead reaches across the entire spectrum of publicly traded concerns. Seemingly, no major industry has dodged the bullet: claimants have pursued cases against transportation, manufacturing, insurance, medical, energy, technology, environmental mitigation, service and retail, and telecom companies, to offer an incomplete list. Regional restaurant chains and global enterprises alike have been accused of retaliating against employees who purportedly were only trying to protect investor interests.

Yet, for all the litigation, the reach of the SOX whistleblower protection law continues to remain undefined – not just gray around the fringes, but ambiguous on some of the core issues: What employee activity is protected by the law? To what extent are non-public subsidiaries at risk? If subsidiaries are not at risk, can public companies avoid the risk of SOX whistleblower claims altogether by structuring the enterprise so that the publicly traded entity operates solely through employees employed by subsidiaries?

Why the continued absence of clarity? The lack of definition in part is due to the simple fact that resolving the merits of a SOX claim can take years. Rulings on the merits of claims that might help define the parameters of the law are slow in arriving, even if the number of complaints filed has grown rapidly. That is true whether the case proceeds before the DOL or in federal court. For example, at its current pace, the DOL’s Administrative Review Board – the final interpreter of the whistleblower provisions at the DOL – requires two years and sometimes longer to review recommended decisions issued by administrative law judges. Therefore, only now are we beginning to see significant rulings in SOX cases by the Administrative Review Board. Moreover, even belated Board rulings do not necessarily provide the final word on an issue, as they may be appealed to the federal court of appeals, extending the proceedings by another year or two.

Another reason that the parameters of SOX whistleblower claims lack delineation is that a large number of cases are resolved on grounds other than the merits of the retaliation allegation. According to preliminary figures from the DOL, in the just-wrapped-up federal fiscal year 2006, employees filed 216 complaints under Section 806 (see chart).

During the same fiscal year, 132 cases were docketed at the Department of Labor’s Office of Administrative Law Judges (OALJ), which compares to 114 the prior fiscal year. Of the cases docketed with the OALJ during FY2006 and disposed of by the presiding judges at press time, approximately 15% were dismissed because

Sarbanes-Oxley Complaints						
	Cases		Complaint Determinations			
	Received	Completed	Withdrawn	Dismissed	Settled/Merit	Total
FY 2002	3	1	1	0	0	1
FY 2003	146	80	14	56	9/11	81
FY 2004	184	175	24	127	23/29	180
FY 2005	285	250	38	192	27/36	266
FY 2006*	216	247	30	159	47/47	256
Cumulative	834	753	107	534	106/123	784

* Preliminary figures

Note that when cases have multiple complainants, the determinations for each complainant are counted separately. As a result, the total number of determinations is higher than the number of cases completed. Also note that settled are a subset of merit cases.

Source: U.S. Department of Labor

they were not timely filed. (Plaintiff’s lawyers also claim that they turn away a fair number of cases because the limitations period has already expired by the time that the complainant contacts them.) DOL judges have strictly enforced the 90-day statute of

limitations that applies to SOX claims, and by dismissing claims for lack of timely filing, they need not reach the merits of a complaint or issue substantive rulings about how Section 806 applies.

In addition to the many claims dismissed on procedural grounds, the statistics indicate that a significant share of cases are withdrawn or settled. Approximately 20% of the FY2006 SOX cases resolved at the ALJ level were withdrawn, and therefore dismissed, because the complainant elected to re-file his or her retaliation case in federal court. (Section 806 permits complainants to file a new complaint in federal court if the DOL has not issued a final order on the complaint within 180 days.) For their part, the federal courts have not elaborated much on the parameters of SOX because their decisions have been few and far between.

While it is certainly not unusual for parties in employment litigation to settle their dispute prior to trial, there appears to be a particular inclination on the part of both sides to settle SOX retaliation claims. From the employee's perspective, he or she may have filed a complaint quickly if only to meet the 90-day limitations period, knowing all along that the complaint lacked significant merit. In such instances, the employee would naturally be inclined to accept a modest settlement. From the corporate perspective, a characteristic reaction of corporate leadership is to endeavor to dispose of a SOX claim quickly. Legal advisors naturally look for an easy exit — such as the statute of limitations. If that does not work, settlement typically has merited serious contemplation.

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One explanation for this interest in settlement is that corporate management simply dislikes having a SOX whistleblower case hanging around. Even though the claim deals with an *employment* issue, and even if the claim might lack a great deal of merit, the presence of a pending claim carries an inference (accurately or mistakenly drawn) of a larger corporate governance problem. Consider: An employee who claims he was fired for revealing alleged backdating of options may have been fired for unrelated legitimate reasons, but no public company desires for that type of allegation to linger any longer than necessary. Nor would the typical corporation desire to submit to wide-ranging discovery requests about its options-dating practices. It is not uncommon for the leadership of private subsidiaries named in a complaint to receive pressure from a publicly traded corporate parent to dispose of the case as promptly as is feasible.

Another concern in the securities arena is that the record in the DOL proceeding or NASD arbitration perhaps may provide fodder in a subsequent SEC enforcement or

criminal proceeding. Finally, unlike the typical wrongful termination case, Section 806 permits complainants to sue individuals, typically executives, in their individual capacity.

The FY2006 statistics bear out that the parties in SOX cases show an inclination to settle. The DOL statistics indicate that OSHA settled nearly 50 SOX complaints in that fiscal year. Likewise, of the FY2006 SOX cases disposed of at the OALJ level at press time, approximately 40% were settled (or withdrawn/dismissed voluntarily, probably due to settlement).

Some inroads into the interpretation of the scope of SOX Section 806 have been made, of course, in recent years. For example:

- The Board has set a standard as to whether a complaint should be dismissed because the complaint did not name a publicly traded company. Over the years, a line of cases had developed that if the complaint did not name a public company as a respondent, dismissal was in order because SOX Section 806 does not apply to private concerns. However, the Board ruled earlier this year that a SOX complaint against only a private entity, such as a wholly owned subsidiary (or, for that matter, against an individual officer) may be viable if the complainant's theory is that the subsidiary was acting as a publicly traded company's "agent" when it engaged in the alleged retaliation. The Board remanded that case (*Klopfenstein*) to the administrative law judge who more recently (and taking a jab at the Board for "scolding" him) again dismissed the case. In dismissing, the judge held that the employee had no claim against a Vice President named as a respondent because the VP had not participated in (and therefore could not be liable for) the employee's termination. The judge also found that, although a wholly owned subsidiary acted as its public parent's "agent" in the termination, the subsidiary had a legitimate reason for the termination (violation of the corporate parent's revenue-recognition policy). The Board's adoption of a standard on this topic is a welcome development, although this particular standard is sure to generate significant litigation in its own right: parties now will debate whether one corporate entity acted as the "agent" for another under general common law agency doctrine.

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- It seems clear that an agreement between employer and employee to arbitrate employment disputes will be a valid basis on which to compel arbitration of a

SOX whistleblower claim, which would avoid the DOL/federal court adjudication process altogether. A recent ruling by a federal district court, consonant with prior cases, has reaffirmed that SOX Section 806 claims are not exempt from mandatory arbitration agreements. The employee in that case attempted to avoid arbitration by arguing that mandatory arbitration contravened the public policy underlying SOX. The employee reasoned that SOX requires transparency in corporate dealings, whereas the arbitration process was not public, particularly because the arbitration agreement in question included confidentiality provisions. The court rejected the argument and compelled arbitration. Additionally, this year the Second Circuit Court of Appeals held that arbitrators — not a court — must decide whether a SOX whistleblower claim is subject to arbitration or is an “employment discrimination” claim which is exempt from mandatory arbitration under NASD rules.

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- Another point of unanimity is that foreign employees are not covered by SOX. The court decisions on this topic have concluded that, with the possible exception of employees working on foreign soil on a temporary assignment, SOX claims are available only to domestic workers.
- The boundaries of employee conduct that is deemed protected activity under SOX continue to be demarcated in the decisions of the DOL and courts. Some points of law are clear. For example, complaining of violations of state law or regulations does not qualify as a protected activity. Likewise, a recent opinion by the DOL’s Administrative Review Board makes clear that an employee cannot successfully fit his or her case into the confines of a SOX whistleblower claim simply by alleging that the alleged wrongdoers must have used the mail or wire transfers to perpetuate some kind of fraud. Rather, when a SOX whistleblower complaint is grounded in federal mail and wire fraud statutes, “the alleged fraudulent conduct must at least be of the type that would be adverse to investor’s interests.” In the same decision, the Board adopted precedent developed under other federal whistleblower laws and concluded that the employee’s conduct is protected only if his or her communication about alleged wrongdoing “definitively and specifically” relates to any of the categories of fraud or securities violations listed in Section 806. The law does not provide protection “for all employee complaints about how a public company spends its money and pays its bills.”

The scope of protected activity will continue to be a matter for litigation. At this juncture, the DOL and courts clearly are resisting the temptation to adopt an overly

broad interpretation of protected conduct. However, an ALJ this year left the door open to the possibility that complaints about race discrimination may qualify as SOX-protected activity if the complainant can demonstrate the effect of the alleged discrimination on investors.

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Many more issues regarding the reach of SOX Section 806 remain to be resolved, including such major issues as the right to a jury trial in a case transferred by the complainant to federal court, an issue that has not yet generated many decisions; the scope of remedies available in SOX cases, including whether the statute implicitly permits all forms of relief or, rather, limits awards to equitable relief; and so on.

The relationship between SOX and state law wrongful discharge claims is another topic on the litigation horizon. In one important respect, the SOX whistleblower provisions did not add an entirely new threat to employers, because most states recognize common law actions for wrongful discharge where the discharge is contrary to public policy. In most instances, a wrongful discharge claim is available for at least some types of whistleblowing. Although SOX claims, as federal claims, are distinct from state law claims, there are points where the laws intersect. A recent California court decision permitted a state law wrongful discharge claim to proceed on the basis that the employee’s conduct was protected by SOX. (Specifically, the employee had informed his employer that, in anticipated testimony to the SEC about market timing, he would “tell the whole truth and let the chips fall where they may.”) On the other hand, SOX Section 806 has the potential to *limit* state law claims: Courts are likely to be receptive to a defense argument that, if the plaintiff could have pursued a SOX claim before the DOL or in federal court, state common law should not be stretched to afford the employee a separate cause of action.

While non-profit corporations are generally not subject to most provisions under SOX, they are subject to Section 1107 whistleblower protections, which carry criminal penalties. While a non-profit is currently only subject to Section 1107 criminal penalties for whistleblower retaliation (not Section 806), the U.S. Senate Finance Committee, the Panel on the Nonprofit Sector, has prepared a report to make recommendations to Congress to improve the governance and oversight of charitable organizations. Many of the reforms are modeled upon SOX. The report erroneously states that existing legal provisions can subject a non-profit to civil liability for retaliation against a whistleblower and thus concludes that no additional legislative action is necessary on this point. Nevertheless, non-profits in the future may be subject to civil liability for retaliating against employees for raising concerns.

The SOX whistleblower provisions undoubtedly add a new layer of risk in the employment law sphere. This risk continues to be one that merits attention. For employers, the best way to address the potential for whistleblower retaliation claims continues, of course, to focus on prevention. In this context, prevention means taking proactive steps to foster a workplace culture that embraces both the reporting of concerns — in a way that makes employees feel valued and appreciated for doing so — and the commitment to resolving concerns. Sound corporate concern reporting and communications strategies can minimize the risk.

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