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Whistleblower Claims Under the Sarbanes-Oxley Act of 2002

Outten & Golden LLP
Laurence S. Moy, Esq.
Linda A. Neilan, Esq.
Hollis Pfitsch (Summer Associate)
3 Park Avenue, 29th Floor
New York, New York 10016
Telephone: 212-245-1000
Facsimile: 212-977-4005

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I. Introduction

In the wake of recent accounting and corporate scandals, Congress passed the Sarbanes-Oxley Act of 2002 (hereinafter, "Sarbanes-Oxley," "SOX," or the "Act"), Public L. No. 107-204, Sec. 806, codified at 18 U.S.C. § 1514A.[1] In addition to providing greater oversight of the accounting industry and protecting investors, the Act prohibits employers from retaliating against whistleblowers. ("Whistleblower" might be considered a misnomer since the Act's scope is not limited to employees who "blow the whistle" by refusing to engage in illegal or wrongful acts or by reporting such activities to the employer or the appropriate authorities.) The Act provides extensive coverage to employees who report improper conduct as well as employees who participate in proceedings relating to same. Companies that fall under the purview of Sarbanes-Oxley are prohibited from discharging, demoting, suspending, threatening, harassing, or discriminating against any employee who engages in protected activity. 18 U.S.C. § 1514A(a).

Prior to Sarbanes-Oxley's enactment, federal and state whistleblower statutes provided limited protection for a narrow class of employees. The False Claims Act covers employees only if they report fraud on the federal government. 31 U.S.C. § 3730(h).[2] In New York, a state statute had provided pre-Sarbanes-Oxley whistleblowers with *extremely* limited coverage. That statute, New York Labor Law § 740, only protects an employee who "discloses, or threatens to disclose to a supervisor or to a public body an activity, policy or practice of the employer that is in violation of law, rule or regulation which violation creates and presents a substantial and specific danger to the public health or safety." N. Y. Lab. Law § 740(2). Thus, Sarbanes-Oxley has vastly changed the horizon of protection for whistleblowers in the private sector.

This paper addresses the whistleblowing provisions of the Act and its accompanying regulations, provides guidance to lawyers advising companies responding to potential whistleblower complaints of improper conduct, and reviews the duties of lawyers to report wrongful conduct as per the Securities and Exchange Commission's ("SEC" or "Commission") new regulations.

II. Provisions of the Act

A. Employees Covered by Sarbanes-Oxley

Sarbanes-Oxley provides broad coverage to current and prospective employees of publicly traded companies as well as individuals whose employment is affected by the company. The regulations define an employee as an "individual presently or formerly

[1] Attached are copies of the statute and the regulations.

[2] See also Clean Water Act (33 U.S.C. § 1367(a)); Clean Air Act (42 U.S.C. § 7622(a)); Toxic Substances Control Act (15 U.S.C. § 2622(a)); and Energy Reorganization Act (42 U.S.C. § 5851(a)(1)).

working for a company or company representative, an individual applying to work for a company or company representative, or an individual whose employment could be affected by a company or company representative." 29 C.F.R. § 1980.101.

B. Employers Covered by Sarbanes-Oxley

Publicly traded companies are defined as companies that (1) have a class of securities registered under section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"), or (2) are required to file reports under section 15(d) of the Exchange Act. 18 U.S.C. § 1514A(a). The Act prohibits any officer, employee, contractor, subcontractor, or agent of the publicly trade company from retaliating against a whistleblower. Id. It remains an open question whether there will be individual liability as in discrimination cases brought under the New York State Human Rights Law. See N.Y. Exec. Law § 296(1).

The Act is silent as to whether subsidiaries or affiliates of covered companies are subject to the Act, however, a recent Sarbanes-Oxley decision extended coverage to a subsidiary. In Morefield v. Exelon Serv., Inc., ALJ No. 2004-SOX-00002 (ALJ Jan. 28, 2004),[3] an administrative law judge ("ALJ") denied respondents' motion to dismiss in a case where the complainant was employed by a non-publicly traded corporate subsidiary of a publicly traded company. In finding that the employee was covered by the Act, the ALJ held that "the term 'employee of publicly traded company' . . . includes *all employees* of every constituent part of the publicly traded company, including, but not limited to, subsidiaries and subsidiaries of subsidiaries which are subject to its internal controls, the oversight of its audit committee, or contribute information, directly or indirectly, to its financial reports." Id. (emphasis added). Earlier Department of Labor ("DOL") decisions addressing this issue, however, have resulted in contrary findings. See, e.g., Powers v. Pinnacle Airlines, Inc., ALJ No. 2003-AIR-12 (ALJ Mar. 5, 2003) (dismissing an airline whistleblower case against a subsidiary because it was not a publicly traded company although the publicly traded parent corporation had been added after the original complaint was filed at the DOL).

C. Protected Activity

Covered employees are protected if they engage in one of two forms of protected activity: (1) providing information regarding improper conduct; or (2) participating in a proceeding. 18 U.S.C. § 1514A(a)(1) and (2). As for the first form of protected activity, Sarbanes-Oxley protects employees who provide information, cause information to be provided, or assist in an investigation regarding conduct that they "reasonably believe" constitutes a violation of enumerated criminal statutes, any SEC rule or regulation, or any federal law relating to shareholder fraud. The enumerated criminal statutes are mail fraud (18 U.S.C. § 1341), wire fraud (18 U.S.C. § 1343), bank fraud (18 U.S.C. § 1344), and securities fraud (18 U.S.C. § 1348). Employees are protected if they provide information to anyone within one of the following three categories: (a) a federal regulatory or law

[3] This and other decisions of the Office of Administrative Law Judges are available at http://www.oalj.dol.gov/libwhist.htm.

enforcement official; (b) a member of Congress or any congressional committee; or (c) a person with "supervisory authority over the employee" or a "person working for the employer who has the authority to investigate, discover, or terminate misconduct." Id.

Regarding the second category of protected activity (participating in a proceeding), employees are protected if they "file, cause to be filed, testify, participate in, or otherwise assist in a proceeding" relating to the enumerated statutes above or any SEC rule or regulation or any provision of federal law relating to shareholder fraud. 18 U.S.C. § 1514A(a)(2). The Act does not define "proceeding," however, it does include proceedings filed or "about to be filed," which arguably extends protection to employees who investigate fraud violations or respond to government subpoenas even in the absence of a formal proceeding. The legislative history supports this finding because it states that the Act would protect employees "when they take lawful acts to disclose information or otherwise assist criminal investigators, federal regulators, Congress, supervisors (or other proper people within a corporation), or parties in a judicial proceeding in detecting and stopping fraud." 148 Cong. Rec. S7418-01 (daily ed. July 26, 2002).

D. Procedures

The administrative proceedings under Sarbanes-Oxley differ from those familiar to most securities and employment lawyers based on matters involving the SEC or the Equal Employment Opportunity Commission ("EEOC"). Employment lawyers, in particular, who are experienced with representing employees at the EEOC in employment discrimination cases, will see some parallels between Title VII (the federal discrimination statute) and Sarbanes-Oxley, but the SOX statute and regulations depart radically in the area of how claims are adjudicated.

The regulations that govern the enforcement of Sarbanes-Oxley are modeled after the Wendell H. Ford Aviation Investment and Reform Act for the 21st Century ("AIR21") (49 U.S.C. 42121(b)) and the Energy Reorganization Act ("ERA") (42 U.S.C. § 5851). AIR21 prohibits discrimination against air carriers or contractors or subcontractors of air carriers for engaging in protected activity pertaining to any violation of the Federal Aviation Administration or any other provision of federal law relating to air carrier safety. ERA protects employees in the nuclear energy industry who report their employers' violations of the Atomic Energy Act of 1954.

1. The DOL Investigation

Sarbanes-Oxley provides an *extremely short* filing deadline. Employees who claim that they were retaliated against for engaging in protected activity must file complaints at the DOL within *90 days of the violation*.[4] To date, communications with DOL representatives has yielded conflicting answers about whether the agency will honor tolling agreements. Thus, caution dictates that aggrieved employees file their claims within 90 days of the violation rather than execute a tolling agreement.

[4] Attached is a timeline of the investigative process at the DOL, the hearing, and the review stage.

The DOL will not conduct an investigation unless the complaint states a *prima facie* case that the protected activity was a "contributing factor" in the unfavorable personnel action. 29 C.F.R. § 1979.104(c). A contributing factor includes *"any **factor** which, alone or in connection with other **factors**, tends to affect in any way the outcome of the decision*." Halloum v. Intel Corp., 2003-SOX-7 (ALJ Mar. 4, 2004) (citing Marano v. Dept. of Justice, 2 F.3d 1137, 1140 (Fed. Cir. 1993) (citations omitted)) (emphasis in original). Further, the employee does not need to prove that the protected conduct was a "'significant,' 'motivating,' 'substantial,' or 'predominant' factor in an adverse personnel action." Id. Specifically, the regulations state that the employees must allege facts and evidence to make a *prima facie* showing that:

(i) The employee engaged in a protected activity or conduct;
(ii) The named person knew or suspected, actually or constructively, that the employee engaged in the protected activity;
(iii) The employee suffered an unfavorable personnel action; and
(iv) The circumstances were sufficient to raise the inference that the protected activity was a contributing factor in the unfavorable action.

29 C.F.R. § 1980.104(b)(1). If appropriate, the DOL will interview the employee to determine if a *prima facie* case has been established. 29 C.F.R. § 1980.104(b)(2). Typically, the employee meets the burden by showing a close temporal proximity between the protected activity and the adverse employment action. 29 C.F.R. § 1980.104(b)(2). In the absence of a showing of a *prima facie* case, the DOL will dismiss the charge. Id.

If an employee establishes a *prima facie* case, the DOL conducts an investigation to determine if there exists reasonable cause to believe that a violation of the Act has occurred. As part of its investigation, the DOL notifies the employer of the complaint and provides it with the opportunity to file a response within 20 days of its receipt. 29 C.F.R. § 1980.104(c). The employer may submit written statements and affidavits or any documents supporting its position as well as request a meeting or interview with the DOL to present its position. Id. The DOL will dismiss the charge if the employer demonstrates by *clear and convincing evidence* that it would have taken the same unfavorable personnel action in the absence of protected activity. Id.

Prior to the issuance of the DOL's findings and a preliminary order, if the DOL has reasonable cause to believe that the employer violated the Act and that preliminary reinstatement is warranted, the DOL contacts the employer and gives notice of the substance of the evidence supporting the employee's allegations. 29 C.F.R. § 1980.104(e). The DOL does so by sending the employer a "due process letter." In response to such a letter, the employer has 10 days to submit a written response, present further evidence, and/or meet with the DOL. Id. Due process requires that the DOL provide the employer with "prereinstatement notice of the employee's allegations, notice of the substance of the relevant allegations, notice of the substance of the relevant supporting evidence, an opportunity to submit a written response, and an opportunity to meet with the investigation and present statements from rebuttal witnesses." Brock v.

Roadway Express, Inc., 481 U.S. 252 (1987) (holding that minimum procedural due process was required before the DOL issued reinstatement of employee).

The regulations state that the DOL must complete its investigation within 60 days of the filing of the complaint. 29 C.F.R. § 1980.105(a). (The DOL does not always meet this deadline, however, and there appears to be no direct consequence that results from the DOL taking longer than 60 days to accomplish this task.) Upon completion of the investigation, the DOL issues written findings as to whether or not there is reasonable cause to believe that the employee was discriminated against in violation of the Act and a preliminary order providing relief to the employee. 29 C.F.R. § 1980.105(a)(1).

2. Settlement

If the parties reach a settlement agreement during the investigative stage, it must be approved by the DOL. 29 C.F.R. § 1980.111(d)(1). After objections to the DOL's findings and order are filed, any settlement must be approved by the ALJ or the ARB, depending on the posture of the case at that time. 29 C.F.R. § 1980.111(d)(2). A copy of the settlement agreement is filed with the ALJ or the ARB, id., and therefore, would be subject to a FOIA request. Thus, employers interested in settlement but highly sensitive about public disclosure of settlement agreements should consider attempting to settle the matter before the complaint is filed, if possible.

3. Remedies

If the DOL finds reasonable cause to believe that the employer violated the Act, it orders all "relief necessary to make the employee whole," which may include reinstatement, back pay, compensation for "special damages," costs and expenses, attorney's fees, and expert fees. 29 C.F.R. § 1980.105(a)(1). The summary of the regulations states that the DOL may offer "economic reinstatement" in lieu of preliminary reinstatement in "appropriate circumstances." The company thus would be required to pay the employee the same compensation and benefits he or she received prior to termination, yet the employee would not return to work. The regulations do not spell out what would constitute "appropriate circumstances," but they would arguably encompass a situation where the employee's position no longer exists or the relationship between the employer and the employee has been so damaged as to render reinstatement impracticable.

Either party may file objections to the DOL's findings and request a hearing within 30 days of receiving the DOL order. 29 C.F.R. § 1980.106(a). All relief is stayed pending the outcome of the hearing *except the order of reinstatement*. 29 C.F.R. § 1980.106(b)(1) (emphasis added). The ability to order reinstatement that is not subject to a stay during an investigatory phase -- i.e., pre-hearing -- pending the outcome of a hearing is a tremendous grant of authority to the DOL. Companies should therefore cooperate fully with the DOL during the investigation and vigorously present their best defense because if the company does not prevail at this stage, the DOL may order reinstatement of the terminated employee.

4. <u>Administrative Hearings</u>

If either party files objections to the preliminary order within 30 days of receiving it, the DOL will conduct a hearing before an ALJ. Pursuant to the regulations, the hearing is *de novo*, on the record, and should "commence expeditiously." 29 CFR § 1980.107(b). To date, there have only been a few ALJ decisions on the merits. The first such decision was <u>Welch v. Cardinal Bankshares Corp.</u>, 2003-SOX-15 (ALJ January 28, 2004) (finding that employer violated the Act by terminating employee after he had reported financial improprieties).[5]

ALJs are granted broad authority to limit discovery in hearings. 29 C.F.R. § 1980.107(b). Further, formal rules of evidence do not apply. 29 C.F.R. § 1980.107(d). Title 29 of the Code of Federal Regulations sets forth the Rules of Practice and Procedure that are generally applicable in administrative hearings before the Office of Administrative Law Judges. <u>See</u> 29 C.F.R. § 18.

Pursuant to the Administrative Procedure Act (the "APA"),[6] the ALJ, subject to the agency rules and within its power, may do the following at an administrative hearing:

> (1) administer oaths and affirmations;
> (2) issue subpoenas authorized by law;
> (3) rule on offers of proof and receive relevant evidence;
> (4) take depositions or have depositions taken when the ends of justice would be served;
> (5) regulate the course of the hearing;
> (6) hold conferences for the settlement or simplification of the issues by consent of the parties or by the use of alternative means of dispute resolution as provided in subchapter IV of [the Act];
> (7) inform the parties as to the availability of one or more alternative means of dispute resolution, and encourage use of such methods;
> (8) require the attendance at any conference held pursuant to paragraph (6) of at least one representative of each party who has authority to negotiate concerning resolution of issues in controversy;

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[5] <u>See</u> <u>also</u> <u>Platone v. Atl. Coast Airlines Holdings, Inc.</u>, 2003-SOX-27 (ALJ Apr. 30, 2004) (finding that employee who reported her reasonable belief of financial improprieties had engaged in protected activity and employer's subsequent termination of her was retaliation); <u>Lerbs v. Buca Di Beppo, Inc.</u>, 2004-SOX-8 (ALJ June 15, 2004) (finding that employee who reported various general financial concerns to management did not engage in protected activity because the concerns were not based on a reasonable belief that the employer's practices were illegal); <u>Klopfenstein v. PCC Flow Tech. Holdings, Inc.</u>, 2004-SOX-11 (ALJ July 6, 2004) (finding that employer demonstrated clear and convincing evidence that it terminated employee for violating revenue recognition policies and not for reporting concerns about "in-transit inventory discrepancies").

[6] <u>See</u> <u>also</u> Attorney General's Manual on the Administrative Procedure Act (1947), located at http://www.oalj.dol.gov/public/apa/REFRNC/agintro.htm.

> (9) dispose of procedural requests or similar matters;
> (10) make or recommend decisions in accordance with section 557 of this title; and
> (11) take other action authorized by agency rule consistent with this subchapter.

5 U.S.C. § 556(c).

Although the APA explicitly states that an ALJ may "issue subpoenas authorized by law," whether ALJs have subpoena power under Sarbanes-Oxley remains an open question. Pursuant to the APA, "[a]gency subpoenas *authorized by law* shall be issued to a party on request and, when required by rules of procedure, on a statement or showing of general relevance and reasonable scope of the evidence sought." 5 U.S.C. § § 555(d), 556(c)(2) (emphasis added); see also 29 C.F.R. § 18.24(a) (stating that the ALJ may "issue subpoenas *as authorized by statute or law*") (emphasis added). At least some counsel within the Solicitor's Office of the DOL, however, are of the view that ALJs lack subpoena power.

Sarbanes-Oxley, like the statutes upon which it was modeled (AIR21 and ERA) does not expressly give ALJs subpoena power. Case law interpreting AIR21 and ERA, however, grants ALJs subpoena power even in the absence of express authority. In a decision interpreting the ERA, the Administrative Review Board ("ARB") reversed its decision in Malpass v. General Electric Co., Case Nos. 1985-ERA-38 and 39 (Sec'y Mar. 1, 1994), which had stated that ALJs lack subpoena power under the ERA because there is no express authorization. Childers v. Carolina Power & Light Co., ARB No. 98-077, ALJ No. 1997-ERA-32 (ARB Dec. 29, 2000). In holding that the ERA implicitly provided ALJs with subpoena power, the ARB in Childers stated:

> [A]dministrative subpoenas have been a staple of federal legislation and agency practice for more than a hundred years. To infer subpoena power from statutory authorization to investigate and enforce compliance with a statute produces anything but a departure from a legal norm. To the contrary, application of the express authorization rule would produce an anomalous result by depriving the agency of an essential and commonplace mechanism for effectuating its duty to assure compliance with the statute.

Id.; see also Peck v. Island Express, ALJ Case No. 2001-AIR-3 (ALJ Aug. 20, 2001) (holding in an AIR21 case that administrative subpoena power is available in whistleblower cases); see also Del Vecchio v. Local 860, 408 N.Y.S.2d 802, 804, 64 A.D.2d 975 (N.Y. App. Div. 1978) ("An attorney has a presumptive right to issue a subpoena . . . in an administrative as well as a judicial proceeding"). But see Bobreski v. EPA, 284 F. Supp. 2d 67, 76-77 (D.D.C. 2003) (holding that the ALJ did not have subpoena authority in a whistleblower case because Congress had specifically withheld subpoena authority in the six relevant environmental statutes). Thus, as demonstrated by the contrary opinions above and information from the Solicitor's Office of the DOL, whether ALJs have subpoena power in Sarbanes-Oxley hearings remains unclear.

The Assistant Secretary may participate as a party, to prosecute the case or petition for review of the ALJ's decision, or as *amicus curiae*. 29 C.F.R. § 1980.108(a)(1). The summary of the DOL regulations states, however, that whistleblowers would most likely be represented by counsel in cases involving corporate fraud. Therefore, the Assistant Secretary would not ordinarily appear except in unique cases, such as cases involving a large number of employees, novel legal issues, egregious violations, or where the interest of justice requires such action. In addition, the SEC may also participate as *amicus curiae*. 29 C.F.R. § 1980.108(b).

The ALJ issues a written determination of the findings and the remedies. 29 C.F.R. § 1980.109(a). The ALJ may only determine that a violation of the Act has occurred if the employee has demonstrated that "protected behavior or conduct was a contributing factor in the unfavorable personnel action alleged in the complaint." Id. The ALJ will not rule in the employee's favor if the employer shows by "clear and convincing evidence that it would have taken the same unfavorable personnel action in the absence of any protected behavior." Id.

If the ALJ finds that the employer violated the Act, the ALJ may order all relief necessary to make the employee whole, including reinstatement with seniority status, back pay with interest, compensation for "special damages sustained as a result of the discrimination," which includes litigation costs, expert witness fees, and reasonable attorney's fees. 29 C.F.R. § 1980.109(b). If the ALJ finds that a complaint was frivolous or brought in bad faith, the ALJ may order the employee to pay a maximum of $1,000 in attorneys' fees to the employer. Id.

If a timely petition for review is filed with the ARB, all forms of relief are stayed *except reinstatement*. If there is no petition for review, then all other forms of relief are effective 10 business days after the ALJ's decision. 29 C.F.R. § 1980.109(c).

5. Review

Either party seeking to appeal the ALJ's decision may file a written petition for review with the ARB within 10 business days of the ALJ's decision. 29 C.F.R. § 1980.110(a). The petition must specifically identify the findings, conclusions, or orders to which the party objects. Id. The ALJ's decision becomes final unless the ARB decides to accept the case for review by order within 30 days of the filing of the petition. 29 C.F.R. § 1980.110(b). If a case is accepted for review, the ARB will issue a decision within 120 days of the conclusion of the hearing. 29 C.F.R. § 1980.110(c). The order of reinstatement remains in effect while the ARB reviews the decision. 29 C.F.R. § 1980.110(b).

The ARB's review of the factual determinations is conducted under the "substantial evidence standard." Id. Substantial evidence is evidence that is "more than a mere scintilla. It [is] relevant evidence as a reasonable mind might accept as adequate to support a conclusion." McDede v. Old Dominion Freight Line Inc., ARB No. 03-107, ALJ No. 2003-STA-12 (ARB Feb. 27, 2004) (citing Clean Harbors Envtl. Servs., Inc. v. Herman, 146 F.3d 12, 21 (1st Cir. 1998) (quoting Richardson v. Perales, 402 U.S. 389, 401 (1971) (citations omitted)).

If the DOL issues a decision within 180 days, then the employee's only remedy is to seek review of the decision before the United States Court of Appeals where the violation occurred or where the employee resided on the date the violation occurred. 29 C.F.R. § 1980.112(a). The employee must file with the Court of Appeals within 60 days of the final order. Id. The Court of Appeals will uphold the decision unless it is "'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law,' and its findings of fact unless they are 'unsupported by substantial evidence' in the record as a whole." Zurenda v. U.S. Dept. of Labor, No. 98-4298, 1999 WL 459775, at * 2 (2d Cir. June 22, 1999) (unpublished opinion) (citing Brink's, Inc. v. Herman, 148 F.3d 175, 178 (2d Cir. 1998) (quoting 5 U.S.C. § 706(2)(A))). There is substantial evidence if a "reasonable mind might consider the evidence adequate to support the finding." Id.

6. Private Cause of Action

If the DOL does *not* issue a final decision within 180 days of the filing of the complaint, the employee may file an action in federal court for *de novo* review. 18 U.S.C. § 1514A(b)(1)(B). Thus, unless the DOL expeditiously conducts an investigation and a hearing before the ALJ and the ARB timely reviews any appeal, it is likely that final decisions will not be issued within 180 days, thereby providing employees with the opportunity to file a cause of action in federal court.

As for arbitration, it remains an open question whether the DOL has the right to investigate an employee's whistleblower complaint if there is a mandatory arbitration agreement. It would appear that mandatory arbitration agreements would not bar an employee from filing a complaint at the DOL. See EEOC v. Waffle House, Inc., 534 U.S. 279 (2002) (holding that an agreement to arbitrate does not bar the EEOC from seeking victim-specific judicial relief on behalf of an employee). If the DOL does not conclude its investigation within 180 days, however, employees cannot file a private lawsuit in federal district court if they are subject to a mandatory arbitration provision in the employment application and/or Form U-4. See Boss v. Salomon Smith Barney Inc., 263 F. Supp. 2d 684 (S.D.N.Y. 2003) (holding that Sarbanes-Oxley whistleblower claims are not exempt from mandatory industry arbitration).

III. Practical Advice

A. Advising Companies Responding to Whistleblower Complaints

Because Sarbanes-Oxley is relatively new legislation, employers should exercise an abundance of caution when responding to potential whistleblower complaints, especially considering the broad parameters of the Act. For example, the Act covers employees who file proceedings relating to shareholder fraud as well as employees who "otherwise assist" in a proceeding. What exactly does "otherwise assist" mean? Does it provide protection to employees who are interviewed by the DOL? Employees who provide supporting affidavits? Until the parameters of the statute are fully defined by the caselaw, employers should treat all employees who play a role in reporting allegations of corporate fraud or misconduct as being covered by the Act.

1. Employers Should Not Take Any Adverse Employment Action Against Whistleblowers

Most importantly, employers *should not take any adverse employment action against a whistleblower*. If an employee accuses the employer of wrongdoing or shareholder fraud, the employer should not terminate, demote, suspend, or otherwise retaliate against the employee. If the employer does decide to take any such action, the employer must be prepared to demonstrate by "clear and convincing evidence" that it would have taken the same action regardless of the protected activity. Clearly, the employer should extensively document its "clear and convincing evidence." Likewise, if the DOL reinstates an employee who was terminated, the company should not treat the employee differently from any other employee in any way.

It is also critical to remember that retaliation against a whistleblowing employee can be illegal even if the employee's reports of corporate misconduct turn out to be unfounded. The Act only requires that an employee act on a "reasonable belief" of illegal activity. Employers should not assume they will escape liability under the Act because they are confident their current operations are lawful.

2. Review Personnel Policies and Procedures

Similar to company policies regarding discrimination and harassment, employers should institute procedures to encourage employees to report shareholder fraud and other improper conduct covered by the Act. Complaint procedures should allow employees to talk to a number of appropriate personnel and provide for anonymity. Employers should assure employees that they will not be retaliated against for engaging in protected activity.

Further, employers should educate all human resource personnel, high-level employees, and corporate officers about the Act.

B. Attorneys as Whistleblowers

Section 307 of the Act directed the SEC to promulgate standards of professional conduct for attorneys practicing before the Commission. Accordingly, the SEC issued regulations requiring attorneys to report material violations of federal and state securities laws.

The standards supplement local standards of professional conduct. 17 C.F.R. § 205.1. If there is a conflict between the SEC's standards and the local standards, the SEC's standards govern. Id.

1. Attorneys Covered by The SEC Regulations

The coverage is fairly broad, applying to all attorneys who "appear and practice" before the SEC, which includes the following: (1) "transacting any business with the Commission, including communications in any form;" (2) representing a client before the Commission or in connection with any Commission investigation, inquiry, request, or subpoena; (3) providing advice about securities laws or the Commission's rules regarding any document submitted to the Commission; and (4) advising a client as to whether information, a statement, an opinion, or other writing is required by the securities laws or the Commission's rules and regulations. 17 C.F.R. § 205.2(a)(1). Attorneys "appear or practice" before the SEC if they advise a client whether any information is required to be filed with the Commission or is incorporated into a document that they know will be submitted to the Commission. Id. The regulations exempt attorneys who conduct the activities mentioned above outside of the context of providing legal services to a client with whom the attorney has an attorney-client relationship. 17 C.F.R. 205.2(a)(2). The regulations also exempt non-appearing foreign attorneys. Id.

2. The Client

The regulations make clear that an attorney's professional and ethical duties are owed to the "issuer as an organization." 17 C.F.R. § 205.3(a). Thus, the attorney represents the corporation. The regulations specifically state that "the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer" but that "does not make such individuals the attorney's clients. Id.

3. The Attorney's Reporting Requirements

Attorneys are required to report "material violations," which are defined as "material violations of applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state securities law or a similar material violation of any U.S. federal or state law." 17 C.F.R. § 205.2(i). This *includes* attorneys who are retained to investigate charges of material violations because they are considered attorneys "appearing and practicing" before the SEC. 17 C.F.R. § 205.3(b)(5). The evidence of a material violation is defined expansively as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." 17 C.F.R. § 205.2(e).

According to the SEC, this is an objective standard which excludes "gossip, hearsay, [or] innuendo." The reporting requirement does not require actual knowledge or a conclusion that a violation has occurred before an attorney must report. See SEC Release No. 33-8185, January 29, 2003, Section-by-Section Discussion of the Final Rule, available http://www.sec.gov/rules/final/33-8185.htm (last viewed Aug. 18, 2004). Rather, upon suspecting a material violation, an attorney must report to the company's chief legal officer ("CLO") or chief executive officer ("CEO"). 17 C.F.R. § 205.3(b)(1).

Doing so "does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation" of the client because, as stated above, the organization is the client, not the officers, directors, or employees who report the material violation. Id. The CLO or CEO then must investigate, and if he or she finds no material violation, he or she must inform the reporting attorney. 17 C.F.R. § 205.3(b)(2).

Unless the reporting attorney reasonably believes the CLO or CEO has responded appropriately within a reasonable time, the attorney must then report to the audit committee of the board of directors, another board committee of independent directors, or the board of directors. 17 C.F.R. § 205.3(b)(3). The attorney may report directly to one of the directors rather than first report to the CLO or CEO if the attorney thinks that would be futile. 17 C.F.R. § 205.3(b)(4).

After reporting the material violations to the CEO or CLO and the directors, if the attorney thinks that there has been no appropriate response, the attorney must explain the reasons for believing this to the CLO or CEO and the directors to whom the attorney reported the material violation. 17 C.F.R. § 205.3(b)(9). An "appropriate response" is a response to the attorney about the material violation from which the reporting attorney reasonably believes that (1) there was no material violation; (2) the issuer has adopted appropriate remedial measures to prevent any material violations from occurring or remedy any violations that have already occurred; or (3) the issuer has retained and directed an attorney to review the material violation and that the issuer then (i) implemented the remedial recommendations; or (ii) had been advised that the attorney may assert a colorable defense on behalf of the issuer. 17 C.F.R. § 205.2(b).

If a company has established a Qualified Legal Compliance Committee ("QLCC"), attorneys only have to report the material violation to the QLCC; they *do not* have to comply with the reporting requirements outlined above. 17 C.F.R. § 205.3(c). Likewise, the CLO may also simply report the material violation to the QLCC. 17 C.F.R. § 205.3(c)(2). Further, an attorney does not have to report evidence of material violations if the attorney has been retained by the CLO to investigate the material violation and the attorney (1) reports the findings of the investigation to the CLO and (2) the CLO and attorney do not reasonably believe that a material violation has occurred and they report such findings to the board of directors or a committee of the board pursuant to 17 C.F.R. § 205.3(b)(3). 17 C.F.R. § 205.3(b)(6). Likewise, the attorney does not have to report evidence of material violations if the attorney was retained by the QLCC to (1) investigate the material violation; or (2) assert a colorable defense in any investigation or judicial or administrative proceeding. Id.

Lastly, subordinate attorneys (i.e. attorneys who appear and practice before the SEC under the direction of another attorney) only need to report to their supervisory attorney (17 C.F.R. § 205.5), who must follow the reporting requirements outlined above (17 C.F.R. § 205.4).

4. Penalties for Failing to Follow the Reporting Requirements

Attorneys who fail to follow these reporting requirements face the same civil penalties and remedies incurred for a violation of the federal securities laws. 17 C.F.R. § 205.6(a). They will be subject to disciplinary authority of the Commission and could be censured or temporarily or permanently barred from appearing or practicing before the commission. 17 C.F.R. § 205.6(b). Attorneys who comply in good faith, however, will not be liable. 17 C.F.R. § 205.6(c). Furthermore, there is no private right of action against attorneys under the Act. 17 C.F.R. § 205.7.

There are no regulations yet on an SEC proposal for what is called a "noisy withdrawal," in which a company would have to report the withdrawal of any attorney because he or she followed the reporting requirements and did not receive an appropriate response.

IV. Conclusion

Representing either an employer or an employee in a Sarbanes-Oxley proceeding perhaps requires an attorney to adopt a different approach than that applicable to most other client representations. The lawyers must adapt to the fact that much of the procedure and law of Sarbanes-Oxley remains unchartered territory. One can adapt by closely monitoring the DOL's investigation during the initial phases of a proceeding, anticipating upcoming issues throughout, being prepared to supply ALJs and adversaries with references to the regulations or case law to support positions taken, and supplementing one's understanding of the law by reviewing any recent developments. The breadth and remedies of Sarbanes-Oxley provide a potent weapon for employees . . . and thus substantial incentives for compliance and care on the part of the employers and their counsel.