

# UNDERSIGHT: The New Overlap Between Securities Law and Employment Litigation

by Daniel P. Westman

**T**he Sarbanes-Oxley Act of 2002 has wrought many changes in the legal landscape. Among other things, Sarbanes-Oxley has created new civil and criminal protections for whistleblowers who raise concerns about potential federal securities fraud. These protections are a significant departure from prior law, which tended to protect only those employees who raised concerns about dangers to the public health and safety, but not those who raised concerns about securities fraud.<sup>1</sup> As a result, employment lawyers who were well equipped to defend traditional whistleblower cases involving public health and safety may be seeking assistance from their colleagues with expertise in the securities laws when defending Sarbanes-Oxley whistleblower claims. Conversely, security lawyers may be seeking assistance from their employment colleagues with regard to SEC investigations that may be triggered by whistleblowers.

Another significant difference from prior law is that Sarbanes-Oxley requires attorneys to be whistleblowers within their clients' organizations when the attorneys believe that clients are committing material securities fraud. Sarbanes-Oxley creates the potential for attorneys—who work in either corporate law departments or at outside law firms—to bring whistleblower lawsuits alleging they were terminated for following their legal obligations to raise their concerns. These developments suggest that securities lawyers may be working more closely with their employment colleagues than ever before.

## Background Regarding the Sarbanes-Oxley Whistleblower Provisions

The whistleblower provisions of Sarbanes-Oxley differ substantially from previous federal and state

whistleblower protections. Until Sarbanes-Oxley, most federal and state whistleblower laws applicable to the private sector protected only employees who raised concerns about issues affecting the public health or safety. Most such laws did not protect private sector employees who raised concerns about fraud against shareholders, because such issues were not perceived as affecting the public health or safety.

In contrast, most federal and state laws protecting government sector whistleblowers did protect government employees who raised concerns about waste of funds. The public interest in financial abuse in the government sector has always been clear, because such abuse involves waste of taxpayer funds. However, until Sarbanes-Oxley the issue of financial fraud in the private sector was viewed as of concern only to shareholders.

With the spectacular failures of several major corporations, and the corresponding investment losses suffered by millions of employees and shareholders, Congress decreed in Sarbanes-Oxley that

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fraud against shareholders is an issue of public concern justifying significant new civil and criminal protections for private sector employees who raise concerns about financial fraud.

Sarbanes-Oxley deviates from the prior pattern of whistleblower protection in numerous respects. For the first time, Sarbanes-Oxley creates a civil remedy for whistleblowers in the private sector who raise concerns about financial matters that implicate violations of federal securities laws. Thus, the subject matter of protected disclosures has been significantly broadened beyond the categories of public health and safety. In addition, the penalties for retaliation against whistleblowing have been greatly strengthened. The civil provisions of Sarbanes-Oxley allow for immediate reinstatement of whistleblowing employees, even before an evidentiary hearing on the merits. Even more dramatically, Sarbanes-Oxley creates severe criminal penalties (including substantial fines, and up to 10 years in prison) for retaliation against whistleblowers who raise concerns about violation of *any* federal criminal statute, not simply laws limited to financial fraud. These criminal penalties may apply to *any* employer, regardless whether the employer is publicly traded or privately held, and may apply to individual managers as well as to corporate employers. Criminal sanctions for retaliation against whistleblowers were extremely rare prior to Sarbanes-Oxley.

Moreover, Sarbanes-Oxley uses whistleblower protection as a key component of federal securities law enforcement. By 2002, the collapses of Enron, WorldCom, and numerous other companies demonstrated that the system of oversight created by the Securities Exchange Act of 1934 had failed to prevent massive financial fraud by several issuers of publicly traded securities. During 2001 and 2002, numerous persons testified before Congress about the reasons for the Enron and WorldCom corporate collapses. The Report of the Senate Judiciary Committee on the bill that became Sarbanes-Oxley states: "In a variety of instances when corporate employees at both Enron and Andersen attempted to report or 'blow the whistle' on fraud, but (sic) they were discouraged at nearly every turn."<sup>2</sup>

In combination with strengthened oversight mechanisms, woven throughout Sarbanes-Oxley is the theme that protection of employees who report financial abuse may help to prevent future corporate collapses and securities frauds—this is a concept I've termed "undersight." "Undersight" is the concept of internal monitoring from the bottom up, which is protected by the employee whistleblower provisions of the Sarbanes-Oxley Act of 2002. Now, corporate insiders who see the daily

operations of companies are protected by Sarbanes-Oxley if they report concerns about financial fraud. In addition to strengthening "oversight" by creation of the Public Company Accounting Oversight Board and other actions, Sarbanes-Oxley also added new "undersight" provisions protecting corporate insiders who witness fraud at first hand. Protection for employees engaging in "undersight" is reflected in many facets of Sarbanes-Oxley:

- Congress required corporate Audit Committees to create mechanisms for receiving anonymous employee concerns about financial improprieties;
- Section 806 creates new civil protection for employees who report concerns about alleged fraud upon shareholders, and Section 1107 creates new criminal penalties for retaliation which extend more broadly than does Section 806;
- Congress required the SEC to issue regulations setting forth minimum standards of practice applicable to attorneys who practice before the SEC. The rules issued by the SEC require attorneys who are aware of financial fraud by their clients to alert the issuers' executive management, and then the issuers' Boards of Directors if executive management does not respond appropriately;<sup>3</sup>
- Sarbanes-Oxley requires the SEC to promulgate rules that prohibit brokerage firms from retaliating against securities analysts because of an "unfavorable research report that may adversely affect the present or prospective investment banking relationship of the broker or dealer with the issuer that is the subject of the research report." This new legal protection for securities analysts was driven by concerns that brokerage firms were pressuring securities analysts to write overly favorable evaluations of stocks in order to obtain additional investment banking business; and
- Congress required issuers of publicly traded securities to disclose whether they have codes of ethics applicable to senior financial officers. Both the New York Stock Exchange and the National Association of Stock Dealers have gone further by requiring companies who wish to maintain their listings on those exchanges to implement codes of ethics not limited to executive management, and to include in such codes provisions that protect employees who report alleged violations from retaliation.<sup>4</sup>

## Summary of Civil and Criminal Protections Under Sarbanes-Oxley

Section 806 of Sarbanes-Oxley creates a federal civil right of action on behalf of any employee of a publicly traded company, or any employee of a contractor of a publicly traded company, who is subject to discrimination in retaliation for reporting corporate fraud or accounting abuses. Section 806 prohibits publicly-traded companies<sup>5</sup> from discriminating<sup>6</sup> against an employee in retaliation for any lawful act done by the employee to: (1) provide information or otherwise assist in any investigation regarding conduct which the employee reasonably believes constitutes a violation of federal securities fraud statutes or SEC rules, provided the investigation is conducted by a federal regulatory or law enforcement agency, any Member of Congress or Congressional Committee, or a person with managerial authority within the publicly traded corporation; or (2) file, testify, participate in, or otherwise assist in any proceeding related to an alleged violation of corporate fraud laws or regulations.

Significantly, Section 806 protects "internal" whistleblowers who provide information during internal corporate investigations, in addition to "external" whistleblowers who bring their concerns to the attention of law enforcement agencies. An employee alleging discharge or other discrimination in retaliation for engaging in any of these protected activities may file a complaint with the U.S. Department of Labor (DOL) not later than 90 days after the date on which the violation occurred.<sup>7</sup>

Section 1107 imposes broad new criminal penalties on any individual who retaliates against whistleblowers for providing truthful information to a law enforcement officer relating to the commission or possible commission of any federal offense. This criminal penalty is not limited to employees of publicly traded companies, is not limited to federal offenses regarding fraud against shareholders, and applies nation-wide.

Section 1107 of the Act, titled "Retaliation Against Informants," imposes criminal penalties on any individual who "knowingly, 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." This provision supplements the existing federal criminal penalties for witness intimidation. The penalties include a fine and/or imprisonment up to ten years. In contrast to the civil remedies created by Section 806, the criminal provisions of Section 1107 are not limited to the

actions of publicly traded companies, nor are they restricted in scope to matters involving corporate fraud or accounting abuses. However, section 1107 is limited to "external" whistleblowers and does not by its terms protect "internal" whistleblowers who only voice concerns within their employers' organizations.

The potential scope of this new criminal statute is very broad. Federal crimes exist under many labor and employment statutes including the Occupational Safety and Health Act (for making false statements; for giving advance notice of inspections); the National Labor Relations Act (for loans by management to unions; for willfully interfering with agents of the Board; for employing felons convicted of certain crimes as union employees); the Employee Retirement Income Security Act (for employing convicted felons as fiduciaries)<sup>10</sup>; the Railway Labor Act (for refusal to obey certain sections of the statute);<sup>11</sup> and many more too numerous to list here. There are federal crimes in the environmental protection statutes, securities statutes, and the Food and Drug Act. In addition, corporations have been criminally prosecuted under the federal conspiracy statute; the Racketeer Influenced and Corrupt Organizations Act ("RICO"); the mail and wire fraud statutes; the Foreign Corrupt Practices Act; the tax laws; the perjury statutes; and the obstruction of justice statutes. In reviewing these partial lists, it is apparent that many employees who provide information to law enforcement officials could potentially fall within the protections of the criminal provisions of Sarbanes-Oxley, and that many companies and individual managers could face criminal prosecutions under Sarbanes-Oxley.<sup>12</sup>

## The Role of "Materiality" in Sarbanes-Oxley Whistleblower Litigation

Both the civil and criminal whistleblower provisions err on the side of employees in several respects, most notably as to what state of mind employees must have in order to be protected. Under the civil remedy created by Section 806, employees need only "reasonably believe" that they are reporting a violation of securities fraud statutes or SEC rules. Moreover, employees need only prove their reasonable belief by a preponderance of the evidence.<sup>13</sup> In contrast, employers must prove their defenses by the higher standard of "clear and convincing" evidence.<sup>14</sup> Under the criminal provisions of Section 1107, employees are protected for reporting "truthful information," whether or not the information proves a violation of federal securities law.

The "reasonable belief" standard under Section 806 has generated some anomalous results to date in several cases in which the employer defended the case on the ground that the alleged fraud complained about by employees did not satisfy the "materiality" standard under federal securities law. In the first case under Section 806 decided on the merits by an Administrative Law Judge (ALJ) employed by the DOL, the plaintiff was the Chief Financial Officer of a small bank.<sup>15</sup> Among other defenses, the bank presented evidence from the bank's auditors which arguably showed that the plaintiff's concerns did not relate to anything material to the bank's financial statements. The ALJ found in favor of the plaintiff, finding that he had a reasonable belief that the bank had violated federal laws or regulations regarding fraud. The ALJ did not determine whether any alleged securities fraud was material.

In another recent case, the plaintiff worked in the accounts payable department and alleged that he had been instructed to delay payments of invoices until later quarters of the fiscal year.<sup>16</sup> The employer used the accrual method of accounting, which meant that the invoices were reflected on the company's books at the time the invoices were incurred, not when they were paid. Accordingly, the company argued that it was legally impossible for there to have been any securities fraud, because delaying the payments of the invoices until later quarters could not have had any effect on the financial statements of the company. Nevertheless, the ALJ found that the employee had satisfied his burden of proving that he had a "reasonable belief" that a violation of statute or regulation had occurred.

These and other decisions may reflect that ALJs employed by the DOL are not necessarily trained in federal securities law. The regulations promulgated under Sarbanes-Oxley address that issue by allowing the SEC to participate in proceedings under Section 806 as *amicus curiae*.<sup>17</sup> However, to date the SEC does not appear to have acted as *amicus curiae* in any significant way. Defendants in Sarbanes-Oxley whistleblower litigation should assume that they, and not the SEC, would have the burden of explaining how federal securities law plays into each case. This will likely require close consultation between employment and securities counsel for the defense.

## The Potential for Litigation Brought by Attorneys

There is a common misconception that Sarbanes-Oxley applies only to publicly traded companies. On the contrary, the civil whistleblower protections apply on their face to "contractors" of publicly traded companies.<sup>18</sup> The coverage of contractors appears to stem from the example discussed in the Congressional debates of employees of the Arthur Andersen accounting firm who could not effectively blow the whistle on the fraud at Enron. Congress appears to have wished to protect employees of accounting firms, law firms, or other contractors of publicly traded companies who report concerns about financial fraud, whether the accounting or law firms themselves were privately or publicly held. Also, the early cases decided under Sarbanes-Oxley have protected employees of privately held subsidiaries of publicly traded companies, on the theory that the finances of the private subsidiaries have an effect on the financial reports of the public parents.<sup>19</sup> Significantly, the criminal protections under Sarbanes-Oxley are not limited to publicly traded companies.

In addition, Sarbanes-Oxley requires the SEC to promulgate rules of professional responsibility for attorneys which require lawyers to report material violations of securities law to their clients' chief legal counsel or chief executive, or if such officers do not respond appropriately, to their clients' Boards of Directors.<sup>20</sup> The SEC has promulgated such rules which broadly define which attorneys are viewed as practicing before the SEC, and potentially include both attorneys who work in corporate legal departments and outside law firms.<sup>21</sup>

These provisions create the possibility for Sarbanes-Oxley whistleblower claims by attorneys, alleging that their employment was terminated in retaliation for carrying out their legal obligations under the SEC rules. To be sure, the ethical obligation of attorneys to preserve attorney-client confidences may present an obstacle to such actions. The DOL has ruled as a matter of federal common law that whistleblowers may not use attorney-client privileged information offensively in order to prove their cases, but may use privileged information only to defend themselves.<sup>22</sup> However, it may be easier for attorneys trained in federal securities law to satisfy their burden of proving their reasonable belief that a violation of securities law took place, because such attorneys should be more well-versed in the concept of materiality than employees without legal training. While this author is not aware of any Sarbanes-Oxley claims having been filed by

attorneys as of this date, prudent companies and law firms should anticipate such claims and implement practices to minimize their risks.

## Reinstatement as a Remedy for Sarbanes-Oxley Violations

In most employment litigation, reinstatement of employment is available as a remedy but is rarely used when the employer-employee relationship has soured. This is particularly so when the employee was a highly-placed executive, and working relations with other executives were damaged.

However, in Sarbanes-Oxley whistleblower litigation, reinstatement appears to be gaining favor as a remedy even where relations between the employer and employee are adversarial. Sarbanes-Oxley contains a relatively unusual provision allowing for immediate reinstatement of whistleblowers before a hearing has been held on the merits.<sup>23</sup> The theory behind this provision appears to be that it is in the public interest to put a whistleblower back on the job in order to deter repetitions of securities fraud.

Two recent decisions have reinstated employees to their jobs, over the strenuous objections of their employers. In the case discussed above in which the Chief Financial Officer filed a complaint against a small bank, the bank argued that the Chief Financial Officer should not be reinstated because he had irreparably alienated the other executives of the bank, its Board of Directors, and its small number of shareholders. Notwithstanding, the ALJ reinstated the Chief Financial Officer to his former position.<sup>24</sup> In another recent case, two former vice presidents were ordered to be reinstated to their positions after they raised concerns about fraud.<sup>25</sup> The reinstatement of two executives who accused their company of fraud is even more remarkable.

The prospect of reinstatement -- either immediately before an evidentiary hearing on the merits, or as a final remedy after a hearing on the merits -- argues even more in favor of protective measures to reduce the risk of Sarbanes-Oxley whistleblower litigation.

## Steps Employers May Take to Reduce the Risk of Whistleblower Litigation

The following are some steps companies can take to avoid such claims:

1. **Establish an Employee Concerns Program.** Establishing a forum in which employees can raise concerns and have some assurance that their concerns will be investigated is an effective means of resolving an employee's grievance

before the employee files a complaint. In addition, an Employee Concerns Program (ECP) can serve as an "early warning system" to alert management of wrongdoing early on, thereby providing an opportunity to intervene and prevent further damage.

2. **Train Managers and Supervisors to Instill a Corporate Culture Conducive to Employees Raising Their Concerns.** One of the lessons of the recent accounting scandals is the importance of maintaining a culture conducive to raising concerns. Indeed, Congress appears to have concluded that many of the companies whose conduct precipitated Sarbanes-Oxley had cultures in which employees were discouraged from raising concerns.
3. **Take Disciplinary Action Against Those Who Engage in Retaliation.** All employees should be put on notice (e.g. through training and the employee handbook) that if they harass or discriminate against another employee for raising a concern, they will be subject to disciplinary action.
4. **Document Performance Issues, Contemporaneously.** To satisfy the "clear and convincing evidence" standard for defenses, it is critical to have thorough, unambiguous evidence demonstrating that the same unfavorable personnel action would have been taken in the absence of the complainant's protected conduct. Accordingly, managers should thoroughly document performance issues on a routine basis. If there is not a contemporaneous documentary record of performance issues, then it may appear that the employer is making up performance issues after the fact to justify the adverse personnel action.

## Conclusion

Sarbanes-Oxley unquestionably intermingled securities law with employment law, especially in its whistleblower statutes. The early Sarbanes-Oxley whistleblower decisions suggest that securities and employment lawyers may become closer colleagues in defending such cases, and in handling SEC investigations that may flow from these cases. The very broad civil and criminal whistleblower provisions under Sarbanes-Oxley suggest that securities lawyers would be prudent to advise their clients now to adopt practices to minimize the risk of Sarbanes-Oxley whistleblower litigation. ■

1 See, e.g., N.Y. Lab. Law § 740 (McKinney 2003) (whistleblower protection limited to employees who disclose legal violations that create a substantial and specific danger to the public health or safety).

- 2 Senate Report No. 107-146, 107th Congress, 2d Sess., at 5.  
3 See 17 C.F.R. Part 205.  
4 See New York Stock Exchange Listed Company Manual, Section 303A, and National Association of Securities Dealers, Inc. Rule 4350(m), and Interpretive Memorandum.  
5 Under Sarbanes-Oxley, any company that must either register its securities or file reports under the Securities Exchange Act of 1934 is considered a publicly traded company.  
6 Discriminatory conduct includes harassment, demotion, suspension, and termination.  
7 Within 60 days after receiving a complaint, and after giving the employer an opportunity to respond, the Occupational Safety and Health Administration (OSHA) will conduct an investigation to determine whether the complaint has merit. Upon completion of the investigation, OSHA will issue a preliminary order which may require reinstatement of the complainant, and payment of back pay with interest and compensation for special damages. Within 30 days of notification of OSHA's findings, either party may file objections. If a hearing is not requested within 30 days, the preliminary order becomes a final order. A hearing will be conducted before a DOL Administrative Law Judge (ALJ), who will issue a recommended decision. Decisions of ALJs may be appealed to the DOL Administrative Review Board (ARB). If the DOL has not issued a final decision within 180 days of the filing of the complaint, the complainant may bring an action in the appropriate federal district court, without regard to the amount in controversy. The employee may recover compensatory damages, including back pay with interest, and special damages sustained as a result of the discrimination, including litigation costs and attorney's fees. In addition, a prevailing complainant would be entitled to reinstatement with the same seniority status the complainant would have had but for the discrimination.  
8 See 29 U.S.C. § 666.
- 9 See 29 U.S.C. §§ 186, 504.  
10 See 29 U.S.C. § 1111.  
11 See 45 U.S.C. § 152.  
12 The author is not aware of any criminal prosecutions that yet have been brought under the criminal whistleblower provisions of Sarbanes-Oxley.  
13 18 U.S.C. § 1514(b)(2)(C).  
14 *Id.*  
15 See *Welch v. Cardinal Bankshares Corp.*, 2003-SOX-15 (ALJ Jan. 28, 2004). This decision, and other opinions under Sarbanes-Oxley, is issued by Administrative Law Judges within the U.S. Department of Labor. A comprehensive library of those decisions is posted by the Department of Labor at [www.oalj.dol.gov/public/wblower/refrnc/sox1list.htm](http://www.oalj.dol.gov/public/wblower/refrnc/sox1list.htm).  
16 See *Halloum v. Intel Corp.*, 2003-SOX-7 (ALJ Mar. 4, 2004).  
17 See 29 C.F.R. § 1980.104(a)(copies of complaints are provided to the SEC); § 1980.108(b)(SEC may act as amicus curiae)  
18 18 U.S.C. § 1514A(a).  
19 See *Morefield v. Exelon Services, Inc.*, 2004-SOX-2 (ALJ Jan. 28, 2004).  
20 15 U.S.C. § 7245.  
21 17 C.F.R. Part 205.  
22 See *Willy v. The Coastal Corp.*, ARB No. 98-060 (ARB Feb. 27, 2004).  
23 See 29 C.F.R. § 1980.105(a)(1).  
24 See *Welch v. Cardinal Bankshares Corp.*, 2003-SOX-15 (ALJ Feb. 15, 2005).  
25 See *Bechtel v. Competitive Techs. Inc.*, 2005-SOX-33 (ALJ Mar. 29, 2005).