Employment Implications of Sarbanes-Oxley after Enron, Global Crossing and Worldcom

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INTRODUCTION

In the wake of corporate scandals at companies like Enron, Global-Crossing, and WorldCom, widespread investor mistrust of corporate management has inspired a Congressional response: the Corporate and Criminal Fraud Accountability Act of 2002**.** The Sarbanes-Oxley Act ("Sarbanes-Oxley") establishes federal whistleblower protection for employees of covered companies. The new federal cause of action designed to shield employees from retaliation when they provide information that they reasonably believe demonstrates a violation of federal securities law, the rules of the SEC or "any Federal law relating to fraud against shareholders."

The legislation creates a web of complementary provisions designed to protect and encourage whistleblowers and to prevent retaliation against them. The statute requires public companies to adopt a code of business ethics and to establish an internal procedure to receive, review and solicit employee reports concerning fraud and/or ethical violations. The enforcement scheme includes administrative, civil and criminal enforcement mechanisms and provides for both corporate and individual liability.

I. WHISTLEBLOWER PROVISIONS

A. Covered Entities

1. Companies

The statute applies to all domestic public companies, without exception. It also applies to non-public companies whose debt securities are publicly traded. Companies covered include those whose equity or debt securities are registered under the Securities Exchange Act, those who are required to file reports under the Securities Exchange Act of 1933, and those who have filed a statement for a public offering under the Securities Act of 1933. Foreign companies are also covered so long as they are registered in accordance with the Securities Exchange Act or the Securities Act.

2. Individuals

The statute also extends to officers, employees, contractors, subcontractors and agents of covered companies. Certain individuals, including officers and employees of covered companies, are subject to liability in their personal capacities.

3. Third Persons

Certain sections of the Act also appear to apply to companies and their agents that do business with publicly traded companies, such as contractors and subcontractors, even if they themselves are not publicly traded.

The Act also places quasi-whistleblower disclosure burdens on in-house attorneys at public companies, and on outside lawyers as well.

B. Protected Activity

1. Civil Enforcement

Section 806 of the Act, codified at 18 U.S.C. § 1514A, creates a new civil cause of action in favor of employees of public companies who are retaliated against for their covered disclosures concerning fraud against shareholders, including accountancy violations, violations of SEC rules and related matters.

The Act provides an extensive definition of protected activity:

> No company . . . or officer, employee, contractor, subcontractor or agent of such company, may discharge demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act by the employee –
>
> (1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of the [wire fraud, mail fraud, bank fraud, securities fraud statutes], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders when the information or assistance is provided to or the investigation is conducted by --
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> > -- a federal regulatory or law enforcement agency;
> >
> > -- any member of Congress or any committee of Congress;
> >
> > or
> >
> > -- any person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or
>
> (2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed

> (with any knowledge of the employer) relating to an alleged violation of the [wire fraud, mail fraud, bank fraud, securities fraud statutes], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

2. Criminal Enforcement

Section 1107 of the Act, codified at 18 U.S.C. § 1513, provides criminal penalties for retaliation against a whistleblower who provides truthful information to a law enforcement officer regarding the commission of a federal offense:

> Whoever knowingly , with the intent to retaliate, take 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, shall be fined under this title or imprisoned not more than 10 years, or both.

3. Comparison of Civil and Criminal Penalty Sections

It is important to understand that Section 1107 protects employees of both public and *private* companies who make truthful reports to a "law enforcement officer," where such disclosures relate to the possible commission of a federal offense. Section 806, however, is triggered by both reports to law enforcement **and** by reports of wrongdoing to members or committees of Congress and internal reports to company personnel with supervisory or investigative authority. In either case, under the administrative procedures discussed below, a successful complaint may be immediately reinstated with backpay.

Moreover, employees who prevail in whistleblower cases (whether determined by DOL or a court) are entitled to damages, which may include:

1. reinstatement to the same seniority status that the employee would have had but for the adverse employment action;

2. back pay;

3. interest;

4. all compensatory damages to make the employee whole; and

5. "Special Damages," including litigation costs, reasonable attorney's fees and costs, expert witness fees, and "all relief necessary to make the employee whole."

Sarbanes-Oxley does not provide for punitive damages. The Act does, however, contain a provision making clear that the statute does not preempt state and federal law.

Section 1107 also appears to apply to reports of wrongdoing involving *any* federal law, not just fraud against shareholders. Furthermore, Section 1107 prohibits any form of intentional retaliation, "including interference with the lawful employment or livelihood of any person." This section appears to cover a multitude of employment actions short of adverse employment actions, such as discharge, demotion or suspension.

The overriding distinction between the civil and criminal provisions is, not surprisingly, the potential for prison time.

4. Reports to News Media are not Protected

The Act does *not* protect employee complaints to the news media. Such reports, by themselves, do not constitute whistleblowing under the Act.

C. Administrative Complaints Procedure

1. Short Statute of Limitations

Employees claiming retaliation can file a complaint with the Department of Labor (DOL) within 90 days of an alleged violation.

2. DOL Responsibilities

After receiving a complaint from an employee claiming retaliation, the Secretary of Labor is required to conduct an investigation.

Upon the filing of a complaint, the DOL must inform the party named in the complaint. Within 60 days after the filing, and after affording the party named in the complaint an opportunity to submit a response, the DOL must conduct an investigation.

3. Dismissal of the Administrative Complaint

The DOL will not conduct an investigation and will dismiss the complaint unless the complainant makes a prima facie showing that his or her protected conduct was a contributing factor in the adverse employment action taken by the employer.

If the employee makes a prima facie showing, the DOL must refuse to conduct an investigation if the employer can demonstrate, by clear and

convincing evidence, that it would have taken the adverse employment action notwithstanding the protected activity.

4. Immediate Reinstatement

If, after investigation, the DOL finds that the employee has been subject to retaliation, the DOL must order the employer to immediately reinstate the employee with backpay. Reinstatement orders are immediately effective and are not stayed pending the resolution of any objections or appeals.

5. Appeals

Either an employee or employer may appeal the investigative findings. The party adversely affected may file a challenge within 30 days of the preliminary order, and there will be a full hearing before an ALJ where the employee bears the burden to prove, by a preponderance of the evidence, that the employer retaliated against him or her for engaging in protected activity.

A final order of the agency may be appealed to the United States Court of Appeals in the first instance.

The agency's decision may only be set aside if it is found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in conformity with the law."

D. Federal Court Private Cause of Action

Under Sarbanes-Oxley, employees against whom employers have allegedly retaliated may bring an action in federal court if the Secretary of Labor does not resolve the employee's complaint within 180 days (and there is no showing that such delay was due to the bad faith of the employee).

Employees are entitled to a trial de novo in any court case, meaning that the prior DOL proceedings or findings, if any, will not limit the court.

II. NEW AUDIT COMMITTEE COMPLAINT PROCEDURES

A. Audit Committee For Covered Companies

Section 301 of the Sarbanes-Oxley Act mandates that covered companies establish an audit committee responsible for the appointment, compensation and oversight of the work of the "registered public accounting firm" that is employed on behalf of the company to issue an audit report or for related work.

B. Internal Whistleblower Procedures

The audit committee must establish procedures for the confidential, even anonymous, reporting by employees and individuals outside the company of concerns regarding questionable accounting or auditing matters. 15 U.S.C. § 301(m)(4). Under the whistleblower provisions of Sarbanes-Oxley, internal reports to such committees constitute protected activity subject to the anti-retaliation provisions of the Act. There is no other whistleblower statute administered by the Department of Labor that contains such a provision.

C. Penalties

A covered company that fails to comply with this requirement by the time the SEC issues regulations on Section 301, can be delisted from a national exchange.

III. NEW REQUIREMENTS FOR ATTORNEYS

A. Requirements for Attorneys

Section 307 and its implementing guidelines establish new rules of conduct for any attorney who appears or practices before the SEC:

> Covered attorneys must report "evidence of a material violation of securities law" or "breach(es) of fiduciary dut(ies)" or "similar violation(s)" to a corporation's "chief legal counsel" or "chief executive officer." If these reports do not properly resolve an attorney's concerns, an attorney is required to further report his or her concerns to a company's audit committee or a similar committee. Under the whistleblower provisions, all such reports would likely be considered protected activity.

B. In-house and Outside Counsel

Section 307 does not expressly limit its reach only to in-house attorneys.

IV. CODE OF ETHICS REQUIREMENT FOR SENIOR FINANCIAL OFFICERS

A. Officer-Specific Code

Section 406 of the Act mandates the adoption of a Code of Ethics for senior financial officers. Each reporting company must also promptly disclose failure to adopt such rules or any changes in or waivers from its Code of Ethics.

B. Requirements of a Code of Ethics

Corporate ethics policies typically include (i) the procedures for handling any conflicts between personal and corporate interests, (ii) corporate theft, (iii) improper use of confidential or insider information, (iv) accurate financial and

expense reporting and (v) falsification of company records and financial statements.

The SEC recently issued proposed rules under Section 406, which defines a Code of Ethics as standards "reasonably necessary to deter wrongdoing" and to promote honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; avoidance of conflicts of interest and potential conflicts of interest and internal disclosure procedures; compliance with applicable governmental laws, rules and regulations; prompt internal reporting of code violations; and accountability for adherence to the code. Significantly, the proposed rules require a public company to report on a current basis amendments to, and waivers from, its code of ethics.

While Sarbanes-Oxley requires only that the procedures relate to complaints of accounting, accounting controls and audit matters, companies may choose to incorporate the statute's reporting procedures into more comprehensive codes of conduct or ethics policies. If these procedures are included in a code of conduct or ethics policy that addresses other ethical standards and areas of conduct, the policy should make clear that the audit committee is specifically responsible for handling and responding to complaints about accounting, accounting controls and audit matters, whereas company management may have responsibility for compliance with other standards.

C. Disclosure of Failure to Comply

While the proposed rules recognize that the Act does not absolutely require that companies institute an ethics code, they do make clear that a public company must disclose the reason for any failure to adopt such a code.

V. RELATED DOCUMENT RETENTION MANDATES

A. Document Destruction or Falsification

Sarbanes-Oxley tightens document retention requirements in a way that reinforces and complements its whistleblowing provisions by targeting acts that are intended to impede, obstruct or influence other investigations, including acts done in relation to, or contemplation of, any matter or case arising from whistleblowing.

B. Specific Intent Requirement

The Act prohibits the knowing alteration, destruction, mutilation, concealment, cover up, falsification or making of a false entry in any record, document, or tangible object with the specific intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under Title 11 or in relation to or contemplation of any such matter or case.

Whistleblowers will be protected when reporting destruction of documentation arguably relevant to a covered investigation. The prohibition on document destruction “with the intent to obstruct a federal investigation” appears to apply to more than financial or accountancy investigations.

C. Destruction of Documents Involved in "Official Proceeding"

The second document-retention provision of Sarbanes-Oxley is more limited in scope. The Act amends a witness-tampering statute and focuses on the destruction of documents involved in an "official proceeding." An "official proceeding" generally means a proceeding before a judge or court of the United States, a proceeding before Congress or a proceeding before a federal government agency. Specifically, the Act imposes penalties on any person who "corruptly —

- alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or
- otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so.

This provision prohibits not only destruction of documents, but also the alteration or concealing of documents. It may also apply to those making false entries in a covered document.

D. Criminal Penalties

Whether document destruction relates to a federal agency investigation or an "official proceeding," the wrongdoer may be fined under Sarbanes-Oxley or imprisoned up to 20 years or both.

VI. MULTIPLE-COUNT CLASS ACTIONS

Because the Act does not preempt other federal or state law, it is probable that claims under Sarbanes-Oxley will be joined with other state and federal claims. For example, the same factual allegations that form the gravamen of the complaints in the *Enron* and *WorldCom* cases may now inspire an additional theory of liability under the Sarbanes-Oxley Act, whether in an action brought by an individual complainant who claims to be a whistleblower as well as an injured benefit plan participant and employee stockholder, or in a class action brought by injured internal/employee stockholders, some of whom claim to be whistleblowers. In recent class action litigation, litigants have bootstrapped both ERISA and securities fraud claims on the same factual allegations. Whether an ERISA claim or a securities fraud claim brought against pension plans, benefits administrators and human resource personnel, corporate officers, directors, and investment advisors, plaintiffs typically allege breach of fiduciary duty claims, contending that corporate officers and directors made material misrepresentations about the soundness of company stock and the prudence of investing in company stock, and that they failed to disclose fully and accurately infirmities in the company's stock price.

Courts have consolidated breach of fiduciary class actions governed by ERISA with securities class actions governed by the Private Securities Litigation Reform Act. For example, in *In re: Global Crossing Ltd Securities & ERISA Litigation*, 2002 US Dist LEXIS 16863, 57 actions against Global Crossing were transferred to a multidistrict panel in the Southern District of New York, which

found consolidation based upon common questions of fact in both the securities and the ERISA litigation. In *In re WorldCom, Inc Securities & ERISA Litigation*, 2002 US Dist LEXIS 19661 (SDNY 2002), a judicial panel on multidistrict litigation consolidated and centralized 42 ERISA and securities claims against WorldCom in New York over plaintiffs' opposition to such consolidation.

VII. SUGGESTIONS FOR MODIFYING COMPANY POLICIES AND PROCEDURES

A. Reviewing or Creating Codes of Conduct

Ranging from "we do the right thing" to lengthy tomes, existing Codes of Conduct may not contain all sufficient discussions of corporate ethics or sufficient conflict-of-interest policies for all individuals covered by Sarbanes-Oxley, whether outside or inside directors, corporate officers, or employees. If no such code exists, then a covered company must take action to create a code, or it will be forced to justify its failure under SEC proposed rules. Because of the new accounting and audit requirements in Sarbanes-Oxley, codes of conduct may require revision to incorporate language from the act and to include examples of prohibited conduct. It may be prudent to assign interpretation of the Code of Ethics to an independent officer who serves as the corporate governance officer of a covered entity.

B. Prompt Education of Directors, Officers and Employees

Covered companies may already face allegations of misconduct from whistleblowers under state whistleblower protection acts, such as Michigan's. To

such claims, a claimant may now add a federal cause of action asserting both pre- and post-act conduct. It is critical to educate directors, officers and employees that they may face individual civil and criminal liability should retaliation occur against any whistleblower, including one who claims securities fraud or a federal offense covered under Sarbanes-Oxley. Because the federal act permits an employee to "blow the whistle" based upon a reasonable belief that a violation of law has occurred, an employee should not be retaliated against if [s]he proves to be wrong.

C. Review or Creation of Document Retention Policies

Given the specific prohibitions against destruction, alteration or falsification of documents that relate to a whistleblower investigation or proceeding, a covered company's policies should enshrine the specific Sarbanes-Oxley prohibitions. A company may consider revising and republishing its existing document retention policy to advise of the conduct proscribed and the penalties for violation of the act.

D. Reviewing Insurance Coverages

Since Directors & Officers Liability policies typically exclude wrongdoing in violation of a statute, covered companies should consider whether other types of insurance coverage would be prudent. For example, Employee Practices Liability Insurance may offer some protection against whistleblower claims that arise under Sarbanes-Oxley, to the extent that the complainant alleging

retaliation for whistleblowing is an employee. Such policies often demand that the insurer select counsel, and in sensitive litigation such as that which can arise under Sarbanes-Oxley, the cheapest counsel (the insurer's pick) will certainly not be the most skilled in defending whistleblower claims.

E. Creating Policies and Procedures conforming to Sarbanes-Oxley

As with sexual harassment investigations, a covered company should investigate and remediate claims of corporate fraud and other ethical breaches. In order to demonstrate that it has shouldered its burden under the Act, a company should create a policy on non-retaliation for whistleblowers and a procedure under which whistleblowers may report such claims. Any such procedure should call for independent and unbiased review. It may be prudent to have such a review, investigation or audit conducted by outside counsel for several reasons:

- prompt completion of a thorough investigation may be beyond the resources of in-house counsel;
- avoidance of the appearance of or actual conflicts of interest;
- greater expertise of outside counsel;
- greater appearance of independence and fairness;
- protection of privileges and documents.

This paper prepared from the text of the "Sarbanes-Oxley Act of 2002" and excepts and comments from "The Whistleblower Provisions of the Sarbanes-Oxley Act of 2002" presented at the 2003 ABA Equal Employment Opportunity Committee meeting and "Advising Senior Management and Boards in the Public Eye: Dealing with Alleged High Level Executive Misconduct" presented at the 2002 American Employment Law Council.