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CORPORATE ACCOUNTABILITY

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VOL. 2, NO. 33 PAGES 859-894 **REPORT** AUGUST 13, 2004

HIGHLIGHTS

Compensation Committees Seen as Key to Reforming Exec Pay

Compensation committees must be held responsible for reforming executive pay and start integrating strategic planning into their processes to protect shareholder interests, a Connecticut pension fund official says at the American Bar Association's annual meeting in Atlanta. Donald Kirschbaum, principal investment officer for the state of Connecticut's retirement plans and trust funds, joins other investor representatives and compensation experts in noting recent progress in corporate governance reform, but adds compensation committees need to step in and help shareholders hold companies more accountable—including adopting performance-based executive pay. **Page 863**

SEC Official Finds Volume of Requests for Confidential Treatment Troubling

The Securities and Exchange Commission staff is ''troubled'' by the volume of confidential treatment requests it receives and may take action to thwart any abuse of the system, Alan Beller, director of the SEC's Division of Corporation Finance, says during the American Bar Association's annual meeting in Atlanta. Beller reports the division staff estimates that for fiscal year 2004, it will receive 20,000 confidential treatment requests. **Page 864**

Revised Model Act Would Spell Out Directors' Duties

Proposed amendments to the American Bar Association's Model Business Corporation Act should help to address one of the key contributors to recent corporate scandals—a lack of awareness on the part of directors that disabled them from detecting and preventing the conflicts of interest leading up to corporate downfalls, members of the ABA's Corporate Laws Committee say at the association's annual meeting. In addition to spelling out directors' oversight duties, the proposed changes also call on directors generally to disclose material information other directors should know about when making board decisions. **Page 865**

SEC Staff May Delay Initiatives, Let Firms Focus on Internal Controls

Securities and Exchange Commission Chief Accountant Donald T. Nicolaisen places such importance on public companies and their auditors complying with new internal controls rules and getting ''them right the first time,'' the SEC staff is considering recommending that implementation of other accounting initiatives be delayed, Nicolaisen says. **Page 886**

Analysis & Perspective

WHISTLEBLOWERS: Attorney David Martin and others from the law firm of Covington & Burling provide an overview of what occurs when a whistleblower files a formal complaint under Section 806 of the Sarbanes-Oxley Act and summarize the reported decisions in this area. An employer can minimize potential liability by carefully and regularly documenting activities it takes toward employees, the authors suggest. **Page 890**

ALSO IN THE NEWS

AUDITOR INDEPENDENCE: California Public Employees' Retirement System staff eyes recommending corporate governance strategy changes in a September report on proxy votes related to auditor independence.
The aim is to take a more tailored approach and avoid negative fallout that resulted from the fund's 'zero-tolerance' approach last proxy season to auditors providing nonaudit services to audit clients. **Page 871**

RECORD RETENTION: Once litigation is reasonably anticipated, a client's attorneys must take affirmative steps—beyond merely directing a litigation hold—to ensure that electronically stored information is located and saved for production in discovery, a federal court rules. **Page 873**

DIRECTOR NOMINATIONS: Former Delaware Chief Justice Norman Veasey advises lawyers to forestall a controversial Securities and Exchange Commission proposed rule that would grant shareholders the ability to nominate directors in certain circumstances. **Page 867**

EARNINGS PROJECTIONS: The Seventh Circuit reinstates a proposed class securities fraud suit charging that Baxter International Inc. knowingly made overly rosy projections that led to a significant stock price drop when actual financial results were announced. **Page 875**

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Analysis&Perspective

Whistleblowers

Protection for Whistleblowers Under the Sarbanes-Oxley Act

BY DAVID MARTIN, BARBARA HOFFMAN,
ERIN F. CASEY, AND JOHN COYLE

Section 806 of the Sarbanes-Oxley Act of 2002 confers legal protection upon employees of public companies who report suspected violations of a range of federal offenses including those relating to fraud against shareholders. If a whistleblower believes that he or she has suffered discrimination as a result of the whistleblowing, the whistleblower may bring a private action against both the company and its employees and agents to demand reinstatement and back pay.[1]

On May 28, 2003, the Occupational Safety and Health Administration (OSHA) published an interim final rule implementing these whistleblower provisions (29 C.F.R. § 1980 (2003)). An agency within the Department of Labor, OSHA is charged with promoting safety in the American workplace. In this capacity, it has developed considerable expertise in administering and enforcing a variety of whistleblower statutes in the areas of health and safety, among others, and has been given similar oversight responsibilities for whistleblower cases under the Sarbanes-Oxley Act.[2] Although a Sarbanes-Oxley whistleblower complaint must be filed with OSHA in the first instance, Sarbanes-Oxley uniquely provides the whistleblower with the option of filing a complaint in federal district court if OSHA does not reach a final decision within a specified period of time. This article provides an overview of what occurs when a whistleblower files a formal complaint with OSHA under Section 806 of the Sarbanes-Oxley Act and summarizes the reported decisions in this area.

Eligibility for Whistleblower Protection. For the purposes of the Sarbanes-Oxley Act, a whistleblower is an employee of a public company who provides information regarding any conduct which the employee reasonably believes constitutes a violation of

- any rule or regulation of the Securities and Exchange Commission;
- federal criminal provisions relating to securities, bank, mail and wire fraud; or
- any federal law relating to fraud against shareholders.

If an employee of a public company provides such information to a federal regulatory or law enforcement agency, to a member or committee of Congress, or to a person with supervisory authority over the employee, then that employee is protected by the whistleblower provisions outlined in the act. An employee who assists in any proceeding (whether filed or about to be filed) relating to an alleged violation of the same laws and regulations is also entitled to protection as a whistleblower. Officers, employees, contractors, subcontractors and agents of the company are forbidden from engaging in any retaliation against the whistleblower.[3]

These protections and restrictions apply *only* to employees working for companies with securities registered under § 12 of the Securities Exchange Act of 1934 or companies required to file reports under § 15(d) of the Exchange Act.[4]

[1] Section 806 is often married conceptually with Section 301 of the Sarbanes-Oxley Act, which calls for audit committees of listed companies to establish procedures for ''the receipt, retention, and treatment of complaints received by [the employer] regarding accounting, internal auditing controls, or auditing matters'' and for ''the confidential, anonymous submission by employees of the [employer] of concerns regarding questionable accounting or auditing matters.'' These so-called ''whistleblower provisions'' have been implemented by the Securities and Exchange Commission, the New York Stock Exchange, the Nasdaq Stock Market and the American Stock Exchange. *See, e.g.*, SEC Release No. 34-47654 (Apr. 9, 2003); New York Stock Exchange, *Listed Companies Manual § 303A.06, Audit Committees*; The Nasdaq Stock Market, *NASD Manual Online § 4350(d)(3)*; The American Stock Exchange, *Amex Company Guide § 803*.

David Martin is head of Covington & Burling's securities group in Washington, D.C. Barbara Hoffman is of counsel and Erin Casey was an associate in the firm's New York office. John Coyle is entering his third year at Yale Law School and worked with Covington's Washington, D.C. office during the summer. More information about the securities group is available on the firm's Web site at http://www.cov.com.

[2] OSHA also has jurisdiction over whistleblower provisions such as the Aviation Investment and Reform Act for the 21st Century (49 U.S.C. § 42121, 29 C.F.R. § 1979), the Energy Reorganization Act (42 U.S.C. § 5851, 29 C.F.R. § 24), and the Surface Transportation Assistance Act (49 U.S.C. § 31105, 29 C.F.R. § 1978).

[3] Section 1107 of the Sarbanes-Oxley Act contains a criminal sanction for anyone who intentionally retaliates against any person ''for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense.''

[4] At least one judge has held that Sarbanes-Oxley whistleblower protection also extends to employees of subsidiaries of

Filing the Complaint. A whistleblower who believes that he or she has been discharged, demoted, suspended, threatened, harassed, coerced, or blacklisted as a consequence of whistleblowing may file a complaint with OSHA.[5] Upon receipt of the complaint, OSHA will notify the employer of the allegations contained in the complaint and of the substance of the evidence supporting the complaint.[6] Any complaint must be filed within 90 days of the alleged discriminatory treatment.

If the Secretary of Labor fails to issue a final decision within 180 days of the filing of the complaint, and the delay was not due to bad faith on the part of the complainant, the whistleblower claimant may bring an action for *de novo* review in a federal district court.

Review of the Complaint by OSHA. OSHA conducts an initial review of all Sarbanes-Oxley whistleblower complaints to determine whether the employee has made out a *prima facie* case against the employer. The elements of such a case are as follows:

- the employee engaged in a protected activity or conduct;
- the employer knew or suspected, actually or constructively, that the employee engaged in the protected activity;
- the employee suffered an unfavorable personnel action;[7] and
- the circumstances were sufficient to raise the inference that the protected activity was a contributing factor in the unfavorable action.

If the alleged protected activity is the provision of information by the employee, it does not matter whether the information concerns an actual violation by the employer of the specified laws and regulations; all that is required is that the employee have an objectively *reasonable belief* that the employer's conduct constitutes such a violation.[8] Moreover, if the alleged protected activity is the employee's assistance in a proceeding concerning an alleged violation, neither the existence of an actual violation nor belief in such a violation by the employee is necessary.

A *prima facie* showing is made if the complaint on its face—supplemented as appropriate by interviews with the complainant—alleges the existence of facts and either direct or circumstantial evidence to meet the required showing.

If no *prima facie* showing has been made, OSHA will so advise the complainant and will dismiss the complaint without investigation. If OSHA finds that the complainant has made a *prima facie* showing, an investigation will follow, unless the employer demonstrates by clear and convincing evidence that it would have taken the same personnel action even in the absence of the employee's whistleblowing. The employer is given 20 days from its receipt of the notice of the filing of the complaint to present written statements or affidavits substantiating its position, and to request a meeting with OSHA for the same purpose. If OSHA finds that the employer has made the required clear and convincing showing, it will dismiss the complaint. Otherwise, OSHA will conduct a formal investigation into the merits of the complaint.

Investigation by OSHA. An OSHA whistleblower investigator is instructed to interview individually all company officials who have direct involvement in the case. If the company has notified OSHA that it is represented by counsel, the investigator will contact counsel to arrange interviews with managerial and supervisory personnel. *It is OSHA's position, however, that company counsel does not have the right to be present during interviews of non-management and non-supervisory personnel, and as a matter of practice OSHA will not necessarily notify the company or company counsel of its contacts with such personnel.*[9] OSHA will also redact witness statements or reduce them to summaries as necessary in order to protect the identity of confidential informants.

OSHA's Investigative Findings and Preliminary Order. At the conclusion of its investigation, OSHA will determine whether or not there is reasonable cause to believe that the employer discriminated against the complainant in violation of Sarbanes-Oxley's whistleblower provisions. If OSHA concludes that reasonable cause exists, it will prepare a preliminary order providing the complainant with all relief necessary to make him or her whole.

OSHA's preliminary order may include reinstatement, unless the employer establishes that the complainant is a security risk or OSHA determines that reinstatement is otherwise inappropriate. If OSHA believes that preliminary reinstatement is warranted, OSHA will again contact the employer to give notice of the relevant evidence supporting the complainant's allegations as developed in the course of the investigation. The employer will have an opportunity to submit a written response, to meet with the investigators to present statements from its own witnesses, and to present legal and factual arguments in support of its position. This evidence must be presented within ten business days of OSHA's notification to the employer, unless OSHA and the employer agree otherwise.

A party who disagrees with OSHA's findings may file an appeal with the Chief Administrative Law Judge in the Department of Labor. Any appeal must be lodged within 30 days of receipt of OSHA's findings. If neither party appeals within 30 days, the preliminary order becomes the final decision of the Secretary of Labor and is not subject to judicial review.

Appeal to an Administrative Law Judge. ***Process.*** If a timely objection is filed, all provisions of OSHA's preliminary order are stayed *except those portions of such orders providing for preliminary reinstatement of the employee*. An administrative law judge then conducts a hearing *de novo*, on the record, with broad power to limit discovery in order to expedite the process. The Assistant Secretary of Labor, at his discretion, may partici-

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publicly traded companies, even if the subsidiary itself is not publicly traded. *See Morefield v. Exelon Services, Inc.*, 2004-SOX-2 (ALJ Jan. 28, 2004).

[5] The regulations at 29 C.F.R. § 1980 set forth the Department of Labor procedures governing these cases, many of which are discussed herein.

[6] A copy of the notice to the employer will also be provided to the SEC.

[7] A personnel action is ''unfavorable'' if it is ''reasonably likely to deter employees from making protected disclosures.'' *Halloum v. Intel Corp.*, 2003-SOX-7, p.15-16 (ALJ Mar. 4, 2004).

[8] *See Welch v. Cardinal Bankshares Corp.*, 2003-SOX-15 (ALJ Jan. 28, 2004).

[9] OSHA, ''Whistleblower Investigations Manual,'' http://www.osha.gov/OshDoc/Directive_pdf/DIS_0-0_9.pdf.

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pate as a party, or may participate as *amicus curiae* at any time in the proceedings. The right to participate includes the right to petition for review of the decision of the administrative law judge.[10]

The complainant has the burden of proving the elements of his claim by a preponderance of the evidence. Even if the complainant meets this burden, however, the employer can prevail by presenting clear and convincing evidence that it would have taken the same personnel action in the absence of the employee's whistleblowing.

The final decision reached by an administrative law judge after the hearing must contain findings, conclusions and an order stipulating the remedies (if any) to be provided to the employee.

Remedies. The range of permitted remedies that can be awarded under Section 806 is broad. The administrative law judge can, for example, order reinstatement of the employee to his or her former position with the seniority status that the employee would have had but for the discrimination, back pay with interest, and compensation for any special damages sustained as a result of the discrimination, including litigation costs, expert witness fees and reasonable attorneys' fees.

Appeal to the Administrative Review. Board. The administrative law judge's order may, in turn, be appealed to the Department of Labor's Administrative Review Board. A petition for review must be filed within ten business days of the administrative law judge's decision.

Review by the Board is discretionary. Unless the Board accepts the case for review within 30 days of the filing of the petition for review, the decision of the administrative law judge becomes the final order of the Secretary. If the Board does accept the case for review, the Board will review the factual determinations of the administrative law judge under the substantial evidence standard. The Board's decision is the final order of the Secretary. Like many final agency decisions, it may be appealed to the United States Court of Appeals.

Federal Court Option Available to Employee After 180 Days. As noted above, if the Secretary of Labor fails to issue a final decision in any case brought by an employee under Section 806 within 180 days of its filing, the complainant may bring an action at law or equity for *de novo* review in the appropriate federal district court without regard to the amount in controversy, unless the delay was caused by the bad faith of the complainant.

Thus far, approximately 25 percent of employees in reported Sarbanes-Oxley whistleblower cases have taken advantage of the 180-day limit and opted out of the administrative law system operated by the Department of Labor and into federal district court. To date, no reported federal decision has substantively addressed the Sarbanes-Oxley whistleblower provision.[11] It is thus not yet possible to evaluate how interpretations of the Sarbanes-Oxley Act's whistleblowing provisions by federal courts might differ from those of administrative law judges.

Duration of the Average Whistleblower Case. ***Importance of OSHA Timing.*** Because the complainant may bring an action *de novo* in federal district court if there is no final Department of Labor decision within 180 days, the Department of Labor's timing in Sarbanes-Oxley whistleblower cases is important.

OSHA Preliminary Orders. An analysis of the Sarbanes-Oxley whistleblower cases (through July 15, 2004) posted on OSHA's website indicates that the Department of Labor is not resolving whistleblower cases according to the time limits stipulated by its own interim rules. Those rules state that OSHA ''will issue, within 60 days of filing of the complaint, written findings.'' A review of the 52 reported cases, however, shows that it takes OSHA an average of 90 days to issue a preliminary order with written findings after a complaint is first filed.

Orders on Appeal. OSHA's rules do not establish a formal timeline for administrative law judge and Administrative Review Board decisions in cases in which OSHA's initial findings are challenged on appeal. The rules do provide, however, that if final orders have not been issued within 180 days of a complaint being filed, the employee may bring suit in federal district court. Thus, the statute would seem to envision a 120-day window after OSHA's preliminary findings are released during which time any appeals process within the Department of Labor ought to be completed. A review of the same reported cases described above demonstrates, however, that it takes an average of 160 days for a final order to be issued by an administrative law judge after OSHA's preliminary findings have been made.[12]

Administrative Review Board Final Orders. For those few cases appealed to the Administrative Review Board, an additional 197 days are, on average, required before a final decision is issued.

Summary. A conservative estimate of how long a case lasts from the moment it is filed until a final order is issued by an administrative law judge is 270 days. Moreover, this average does not reflect what appears to be an increasing backlog of cases in the Department of Labor. The average duration of cases handed down in 2003 was 228 days. The average duration of cases reported in the first six months of 2004, by contrast, was 303 days. Charts depicting case duration and disposition are included in the appendix to this advisory.

The Outcome of the 'Typical' Whistleblower Case. Of the 52 Sarbanes-Oxley whistleblower retaliation cases (through July 15) reported on the Department of Labor's website, the majority have been dismissed or withdrawn without reaching the merits: 14 cases were dismissed for reasons of untimeliness or a failure to follow proper procedures; 13 were withdrawn to be refiled in federal (or state) court; 11 were withdrawn or dismissed for unstated reasons; six were settled; and eight were decided on the merits. Of the cases decided on the

[10] The SEC, at its discretion, may also participate as *amicus curiae* at any time in the proceedings. Whether or not the SEC chooses to participate, copies of all pleadings in the case must be sent to the SEC if it so requests.

[11] The only reported decision interpreting the Sarbanes-Oxley whistleblower provision addresses the procedural 180-day requirement. *See Murray v. TXU Corp.*, 279 F. Supp. 2d 799 (N.D. Tex. 2003).

[12] This almost certainly understates the actual delay because the website does not include the initial filing dates for 10 cases that were withdrawn from the administrative courts and re-filed in federal district court (each of which lasted for at least 180 days).

merits, three were decided in favor of the employee and five were decided in favor of the employer.

In those cases that reached the merits, as might be expected, the inquiry was extremely fact-intensive. But, the cases do give rise to several general guidelines.[13]

■ **Credibility Matters**. In each of the cases decided in favor of the employee, the administrative law judge found that the employee told a more credible story than the supervisors. Because credibility is so important in these types of cases, an employer needs to think carefully about how its case will be perceived through both the voice and the demeanor of its witnesses.

■ **Documentation Can Carry the Day**. In one case, officers at a major information technology company documented proceedings at each performance review with a whistleblower *before* he made any allegations of accounting irregularities. This documentary trail—showing a long history of run-ins with colleagues, threats to subordinates, and clear violations of company policies—supported the administrative law judge's finding that the company would have taken the same action regardless of the employee's allegations of retaliation.[14] This highlights one of the benefits of programs that emphasize a written record of substantive meetings with employees.

[13] The eight cases decided on the merits are: *Klopfenstein v. PCC Flow Technologies Holdings, Inc.*, 2004-SOX-11 (ALJ July 6, 2004); *Lerbs v. Buca di Beppo, Inc.*, 2004-SOX-8 (ALJ June 15, 2004); *Harvey v. The Home Depot, Inc.*, 2004-SOX-36 (ALJ May 28, 2004); *Platone v. Atlantic Coast Airlines Holdings, Inc.*, 2003-SOX-27 (ALJ Apr. 30, 2004); *Halloum v. Intel Corp.*, 2003-SOX-7 (ALJ Mar. 4, 2004); *Getman v. Southwest Securities, Inc.*, 2003-SOX-8 (ALJ Feb. 2, 2004); *Welch v. Cardinal Bankshares Corp.*, 2003-SOX-15 (ALJ Jan. 28, 2004); and *McIntyre v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 2003-SOX-23 (ALJ Jan. 16, 2004).

[14] *Halloum*, *supra* note 7. Of course, the creation of a paper trail is not in itself a guarantee that the company will prevail. In another case, a supervisor refused to concede the occurrence of *any* non-documented exchange. *See Platone*, *supra* note 13. The administrative law judge ruled in favor of the employee, holding specifically that the supervisor's unwillingness to acknowledge undocumented exchanges did considerable damage to his credibility. So, while a paper trail may be desirable, slavish reliance upon documentation to the point of denial is not.

■ **Take it Slow, Get it Right**. In another case decided on the merits, a chief financial officer of a publicly traded bank was suspended just 12 days after he circulated a memo reiterating his reasons for having refused to certify the bank's financial statements for the preceding quarter.[15] The administrative law judge noted that ''proximity in time between [the] protected activity and the adverse action is itself sufficient to create an inference of unlawful discrimination'' and that the inference, in this case, was amply supported by other evidence. This suggests the benefits of taking complaints or claims seriously, investigating them thoroughly, and then deliberating on the findings before taking any personnel action—in essence, being sensitive to considerations of due process.

■ **Be Mindful of the ''Reasonable Belief'' Standard.** In a number of the reported cases decided on the merits, the administrative law judges emphasized that it was *irrelevant* whether a company *actually* violated, or intended to violate, any federal fraud statute. All that the Sarbanes-Oxley Act requires is that an employee *reasonably believe* that a company has engaged in such conduct. If the employee is seen to meet that test and discloses that conduct to the federal government or to his employer, then that person is protected against retaliation.

Conclusion. The Sarbanes-Oxley Act significantly expands the protection available to ''whistleblowers'' with respect to possible violations of federal laws and regulations related to fraud and to securities compliance. As a result, an employer should take proactive steps to minimize potential liability by carefully and regularly documenting activities it takes towards employees—whether a regularly scheduled evaluation or an unscheduled personnel action—in a way that can help establish credibility and demonstrate a systemic approach towards handling employee complaints.

Given the uncertainty inherent in any new adjudicatory system it should be no surprise that the time required to resolve whistleblower cases as well as the selection of fora will present interesting questions. Above all else, however, companies facing allegations of whistleblower retaliation will need to be patient as dispute resolution procedures in this new area evolve.

[15] *Welch*, *supra* note 8.

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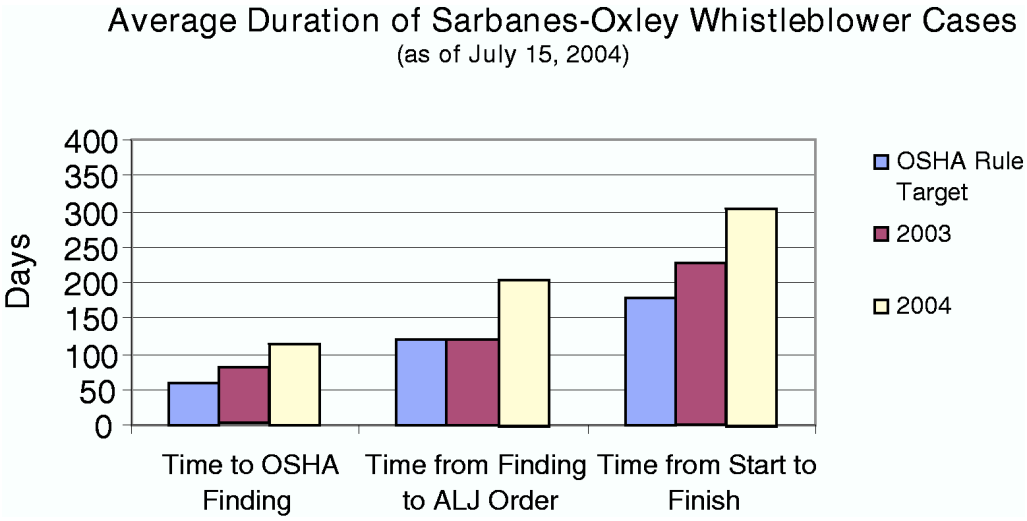
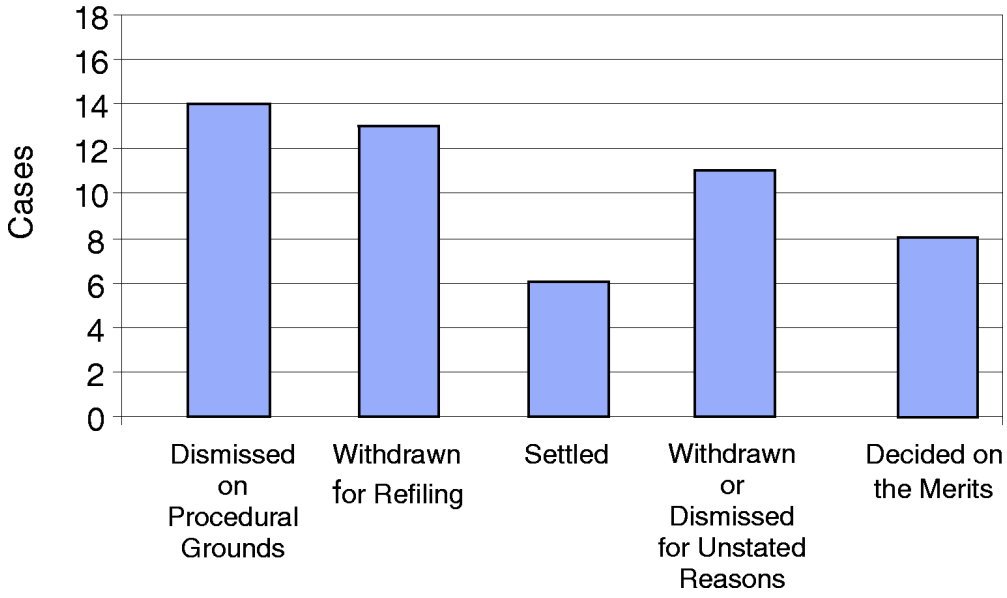
APPENDIX


Average Duration of Sarbanes-Oxley Whistleblower Cases
(as of July 15, 2004)
Days
400
350
300
250
200
150
100
50
0
OSHA Rule Target
2003
2004
Time to OSHA Finding
Time from Finding to ALJ Order
Time from Start to Finish


Disposition of Sarbanes-Oxley Whistleblower Cases
(as of July 15, 2004)
Cases
18
16
14
12
10
8
6
4
2
0
Dismissed on Procedural Grounds
Withdrawn for Refiling
Settled
Withdrawn or Dismissed for Unstated Reasons
Decided on the Merits

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Electronic Resources

VOL. 2, NO. 33 AUGUST 13, 2004

THIS WEEK'S ISSUE

Listed below are the headlines and page numbers of articles in this issue followed by Web sites providing related information.

SEC Opens Bribery Probe Over Foreign Payments by Oil Companies (p. 880)
http://govt-aff.senate.gov/_files/071504miniorityreport_moneylaundering.pdf

EU Commission Abandons Rulemaking on Executive Pay but Seeks Transparency (p. 882)
http://europa.eu.int/comm/internal_market/

Annual SEC Forum to Focus on Auditing, Disclosure Issues (p. 884)
http://www.sec.gov/info/smallbus/sbforum.shtml

AICPA Considering New Ethical Rules on Outsourcing Disclosure, Confidentiality (p. 888)
http://www.aicpa.org

INTERNET SOURCES

Listed below are Web sites consulted by the editors of BNA's Corporate Accountability Report and Web sites for official government information.

ABA Task Force on Corporate Responsibility
http://www.abanet.org/buslaw/corporateresponsibility/home.html

American Institute of Certified Public Accountants
http://www.aicpa.org

Business Roundtable
http://www.brtable.org/index.cfm

Committee of Sponsoring Organizations of the Treadway Commission
http://www.coso.org/

Congressional Record
http://www.access.gpo.gov/su_docs/aces/aces150.html

Council of Institutional Investors
http://www.cii.org

Federal Register
http://www.access.gpo.gov/su_docs/aces/aces140.html

Financial Accounting Standards Board
http://www.fasb.org

Internal Revenue Service
http://www.irs.gov

International Accounting Standards Board
http://www.iasb.org.uk/cmt/0001.asp

Nasdaq Stock Market
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New York Stock Exchange
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Public Company Accounting Oversight Board
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http://www.bna.com/products/corplaw/dtr.htm

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