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Developments Under Sarbanes-Oxley Whistleblower Law: 2007 Update
#12663

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DEVELOPMENTS UNDER SARBANES-OXLEY WHISTLEBLOWER LAW 2007 UPDATE

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January 16, 2007

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DEVELOPMENTS UNDER SARBANES-OXLEY WHISTLEBLOWER LAW
2007 UPDATE

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I. Enforceability of DOL Preliminary Reinstatement Orders

In an important development for employers facing the unsavory prospect of preliminary reinstatement of purported SOX whistleblowers, the Second Circuit on May 1 denied enforcement of a Department of Labor preliminary reinstatement order. Although the decision, *Bechtel v. Competitive Technologies*, No. 05-2404-cv (2d Cir. May 1, 2006), contains no majority opinion, the case nevertheless highlights a number of viable arguments for employers whose termination decisions are challenged under SOX.

A. Factual Background

Bechtel filed a SOX complaint with the Department of Labor, alleging that he was fired because he engaged in protected whistleblowing. Upon investigating the charge, the DOL found reasonable cause to believe that a violation of SOX had occurred. Pursuant to section 806 of SOX and its own regulations, the Agency ordered that Bechtel be reinstated to his former position pending further administrative and/or judicial proceedings. Under SOX, such a preliminary reinstatement order is not stayed upon the employer's filing of an appeal.

Competitive Technologies refused to reinstate Bechtel, and Bechtel filed suit in U.S. District Court to enforce the preliminary reinstatement order. The District Court determined that it had jurisdiction to entertain the action, and issued a preliminary injunction requiring reinstatement. The company appealed.

B. The Second Circuit Reverses

In a 2-1 plurality decision, the Second Circuit reversed and vacated the District Court's injunction. In an unusual twist, each of the three judges articulated a different rationale for his conclusions.

Judge Jacobs rested his decision to reverse on jurisdictional grounds, concluding that the text of SOX simply did not authorize judicial enforcement of preliminary reinstatement orders. While he acknowledged that this rationale would effectively make preliminary reinstatement orders unenforceable, he did not believe such a result was contrary to the legislative intent. Rather, he said, there was reason to believe that Congress intended that the order should not be enforceable. Judge Jacobs noted, for example, that "if the result changes from one level of

review to the next, immediate enforcement at each level could cause a rapid sequence of reinstatement and discharge, and a generally ridiculous state of affairs."

Judge Leval found it unnecessary to decide the jurisdictional question that Judge Jacobs addressed. Instead, he determined that reversal was required because the DOL's actions in issuing the preliminary reinstatement order in this particular case failed to comport with constitutional due process requirements. Specifically, he noted that the DOL failed to provide Competitive Technologies with witness statements, redacted or otherwise, in order to provide the employer with the opportunity to rebut the evidence. Accordingly, Judge Leval concluded, the preliminary reinstatement order was unenforceable.

Judge Straub dissented from the judgment, concluding that (a) the court had implicit authority to enforce the reinstatement order under SOX, and (b) there was no denial of due process. With regard to the former, he looked to the statute as a whole and concluded that "Congress has made clear that it wants employees reinstated *while*, not after, the administrative process goes forward." With regard to the latter, Judge Straub stated that the DOL's investigation constituted "a reliable initial check against mistaken decisions," and therefore met the requirements of procedural due process.

C. Implications for Employers

The Second Circuit judges in *Bechtel* seemed to agree on only one thing: that the SOX whistleblower section, "no matter how it is read, does not make complete sense." But because of the divergence of views in the case, none of which commanded the vote of more than one judge, it remains unclear whether preliminary reinstatement orders may be enforced by federal courts as a matter of law, and the case seems a prime candidate for reconsideration *en banc*.

Still, the significance of this decision should not be underestimated. It reveals strong arguments that employers may assert against enforcement of preliminary reinstatement orders, both on jurisdictional and constitutional grounds. Given that the threat of preliminary reinstatement under SOX has been of particular concern to public companies faced with potential whistleblower claims, the case is surely a welcome development for employers and warrants close attention for further developments.

II. Arbitrability Of SOX Claims To Be Decided By Arbitrators, Not Court

In an unrelated decision, the Second Circuit ruled that an arbitration panel, not a court, must decide whether a whistleblower claim is an "employment discrimination" claim and therefore exempt from mandatory arbitration under NASD rules. *Alliance Bernstein Inv. Research and Mgmt. v. Schaffran*, No. 05-4437-cv (2d Cir. Apr. 12, 2006).

Upon commencement of his employment with Alliance, Shaffran executed a Form U-4, which contained the standard clause requiring arbitration of "any dispute, claim or controversy that may arise between me and my firm ... that is required to be arbitrated under the rules, constitutions, or by-laws of the [NASD]." He did not execute any separate arbitration agreement with the company.

Upon the termination of his employment, Shaffran brought an NASD arbitration, alleging retaliatory termination in violation of section 806 of SOX as well as claims under New York law. In an unusual move, and for reasons the opinion did not specify, Alliance, relying on the U-4, requested that Schaffran withdraw his SOX claim and refile it in U.S. District Court. Schaffran refused, and Alliance then commenced an action for a declaratory judgment that it was not required to arbitrate Schaffran's SOX claims before the NASD.

A. Claims Required to be Arbitrated under the NASD Rules

NASD rules require arbitration of disputes "arising out of the employment or termination of employment" of associated persons at the instance either party, with the following exception under Rule 10201(b):

> A claim alleging employment discrimination...in violation of a statute is not required to be arbitrated. Such a claim may be arbitrated only if the parties have agreed to arbitrate it....

Thus, if a SOX whistleblower claim is determined to be an "employment discrimination" claim within the meaning of Rule 10201(b), then Alliance would be allowed to decline to arbitrate. If, on the other hand, a SOX claim is not deemed an "employment discrimination" claim, arbitration would be required. The issue before the Second Circuit was whether this issue should be resolved by the District Court or by an NASD arbitration panel.

B. Arbitrators To Decide

Looking to both federal law and New York contract law, the court held that the issue of arbitrability is to be decided by courts and not arbitrators, "[u]nless the parties clearly and unmistakably provide otherwise." In this instance, the court said, both Shaffran and Alliance had clearly "provided otherwise" because each agreed to be bound by the NASD Code, Shaffran by signing a U-4 and Alliance by its membership in the NASD. As the Code provides that "arbitrators shall be empowered to interpret and determine the applicability of all provisions under this Code," the court held that the parties agreed that the interpretation of Rule 10201(b) should be made by the arbitrators.

C. Ramifications For Employers

As the Second Circuit observed, it is usually the employer that seeks to compel arbitration of claims that the employee has filed in court. In this case, the roles were reversed. Despite the well recognized advantages of arbitration, there are often compelling reasons for employers to prefer a judicial forum in particular cases, especially where the employer believes it has valid jurisdictional defenses or a strong chance at summary judgment.

The result of this decision is that arbitrators will be required to decide their own authority to address SOX disputes. Regardless of which party prefers the matter to be heard in court, this decision may result in uncertainty as to whether this will occur, as arbitration panels will make these determinations on a non-precedential, case-by-case basis.

III. What Constitutes Protected Activity?

Recent decisions of both federal district courts and the Department of Labor's Administrative Review Board ("ARB") have shed further light on what constitutes protected activity under SOX.

In *Livingston v. Wyeth, Inc.*, No. 1:03CV00919, 2006 WL 2129794 (M.D.N.C. Jul. 28, 2006), a case handled by Orrick attorneys, the plaintiff alleged that he was terminated in retaliation for making ethics and others complaints about training deficiencies and a perceived cover-up of those deficiencies. The district court granted summary judgment to Wyeth on all claims, holding that Livingston did not engage in protected activity under SOX as a matter of law because his reporting did not relate to fraud against shareholders.

The court observed that both the language of SOX and its legislative history support a conclusion that fraud is an integral element of a SOX claim:

> Sarbanes-Oxley was enacted to address corporate fraud on shareholders. One way it does so is by protecting employees who report violations of laws that relate to shareholder fraud. It is clear from the plain language of the statute and its legislative history that fraud is an integral element of a whistleblower cause of action.

The court found nothing in the record or in Livingston's allegations indicating that Wyeth made false or misleading statements or omitted relevant information in any documents provided to its shareholders. The court further held that there was no objectively reasonable basis, at the time of his allegedly protected activity, for Livingston to equate perceived training deficiencies with imminent wrongdoing. Finally, the court held that, whether or not Livingston engaged in protected activity, his discharge was unrelated and was for cause.

In *Platone v. FLYi, Inc*., Case No. 04-154 (ARB Sept. 29, 2006), the ARB reversed a merit finding by the administrative law judge ("ALJ") on the ground that the complainant did not engage in protected activity. Platone had filed a SOX complaint with the Department of Labor alleging that she engaged in protected activity when she reported suspicions that management and union officials were complicit in a scheme to improperly compensate union members for time spent on union business. The ALJ found for her and awarded damages. The ARB reversed that decision, finding that Platone did not report fraud against shareholders, rather, she raised a possible violation of internal union policy and worked with management to resolve a potential billing issue. The ARB held this insufficient to state a claim: "[SOX] does not provide whistleblower protection for all employee complaints about how a public company spends its money and pays its bills. Rather, under SOX, the employee's communications must 'definitively and specifically' relate to any of the listed categories of fraud or securities violations under 18 U.S.C.A. s. 1514A(a)(1)."

IV. SOX Complainant Awarded Substantial Front Pay in Lieu of Reinstatement

In *Hagman v. Washington Mutual Bank Inc.*, ALJ Case No. 2005-SOX-00073 (Dec. 19, 2006), a DOL investigator found reasonable cause to believe that the respondent bank violated SOX. Theresa Hagman's employment was terminated by the bank shortly after her supervisor

learned of a report she made to the bank's Corporate Credit Risk Management Department about short funded loans. Although the bank claimed that Hagman's employment was terminated during a restructuring period due to relatively poor performance, the DOL found this explanation to be pretextual, and awarded Hagman reinstatement, back pay, costs, attorneys' fees, and the fair value of the complainant's stock options.

A. Appeal to the ALJ

In a unique twist, Hagman appealed the DOL's determination of remedy, arguing that she should receive front pay instead of reinstatement. She claimed that she had experienced stress-related health problems due to the bank's misconduct, and that reinstatement was therefore not a viable option due to her health concerns. She also claimed that reinstatement would be inappropriate based on the failure of the bank to implement new protections for whistleblowers, and the failure of the bank to follow its internal procedures with regard to her termination.

B. ALJ Awards Front Pay

The ALJ held that, while reinstatement is the preferred remedy for a SOX violation, front pay may be used when (1) an employee's medical condition is causally related to her employer's retaliatory action; (2) there is manifest hostility between the parties; (3) the complainant's former position no longer exists; or (4) the employer is no longer in business at the time of the decision. The ALJ found that Hagman's rejection of the bank's offer of reinstatement was objectively reasonable based upon the hostility she had already experienced, the bank's lack of preventative measures and its unwillingness to change. The ALJ stated that it was the bank's burden to demonstrate by clear and convincing evidence that reinstatement was the appropriate remedy, and that it did not meet that burden.

Turning to the question of damages, the ALJ found Hagman's expert to be credible and accepted the presumption that Hagman, who is in her mid-40s, did not have equally good employment opportunities after she was discharged, and that it would take until the year 2014 for her career to be back on track. The ALJ rejected the bank's argument that Hagman was only entitled to one year of front pay because her position was set to be eliminated on May 31, 2006, finding that it was highly speculative that this would actually happen. The front pay award was $642,941, which represented the present value of Hagman's loss of earnings and loss of benefits and compensation for the diminution of expected earnings in future jobs until 2014 . Her annual compensation at the time of termination was approximately $175,000.

C. Attorneys' Fees

The ALJ then considered attorneys' fees. Hagman, who was represented by Liddle & Robinson, had claimed $443,368 in attorneys' fees and $57,233.56 in costs. The ALJ found these fees to be unreasonable because these fees were incurred over only a one year period when only a single issue was litigated (her reinstatement) and the attorney's hourly rates were excessive, especially by the Los Angeles standards of where the ALJ and Hagman were located-- Hagman could have found adequate counsel closer to home, especially given the fact that her counsel was competent but not exceptional. The ALJ also reduced the total hours charged by

25% because of excessive block billing of time entries, vague descriptions, duplicate entries, and the attorney's quarter-hour billing standard. This reduced the attorneys' fee award to $263,731.25. The ALJ also reduced the costs awarded to $42,017.46, eliminating costs for photocopying, postage, express mail, FedEx, faxes, working meals, overtime charges, travel and taxi charges, and the purchase of a CFR copy. In total, Hagman was awarded $1,074,205.06 plus interest in damages, fees, and costs by the ALJ.

Hagman is only the fifth SOX whistleblower case in which damages have been awarded by an ALJ, and two of the previous four awards of damages were later reversed by the ARB.

V. Conflicts Between Sarbanes-Oxley 301 and EU Law

Section 301(4) of the Sarbanes-Oxley Act requires the audit committee of every US publicly traded company to establish procedures for "the confidential, **anonymous** submission by employees....of concerns regarding questionable accounting or auditing matters"(emphasis supplied). To comply with § 301(4), many employers have designed whistleblowing systems, such as telephone "hotlines", enabling employees to report potential violations anonymously. However, US publicly traded companies operating in Europe have found that deep-seated ideological differences as to the desirability of anonymous reporting systems have given rise to a conflict between § 301(4) and European data protection laws.

Pursuant to European Union Directive 95/46/EC (the Directive),[1] employers' collection, processing, and use of "personal data" must be consistent with four broad principles:

1. **Legitimacy:** In the whistleblowing context, data processing must be necessary for either compliance with a legal obligation imposed by an EU member-state or furtherance of the legitimate interests of the controller or third party to whom data is disclosed, unless "such interests are overridden by the interests for fundamental rights and freedoms of the data subject."[2]
2. **Fairness:** The data subject must be informed about the entity responsible for the whistleblowing scheme, the facts he/she is accused of, the recipients of the information, and how to exercise his or her rights of access and rectification.[3]
3. **Proportionality:** The processing of personal data "must be adequate, relevant and not excessive in relation to the purposes for which they are collected and/or further processed."[4]
4. **Rights of Access and Rectification:** Data subjects have a right to access data relating to them, and may seek to have inaccurate or incomplete information rectified.[5]

The tension between § 301(4) and data protection laws first came to light after two decisions by the French data protection authority (the CNIL), in which it declared illegal the

[1] Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data, OJ No. L 281, 23.11. 1995, p. 31.
[2] *Id.* at 40.
[3] *Id.* at 41-42.
[4] *Id.* at 40.
[5] *Id.* at 41.

whistleblowing systems proposed by McDonald's France and a French subsidiary of Exide Technologies, due to a concern that the systems created an unreasonable risk of causing "organized systems of denouncement."[6] Subsequently, the CNIL clarified that not all forms of anonymous reporting are prohibited and pointed to several suspect features of the two proposed systems, including their broad scope and failure to consider the use of non-anonymous channels of reporting.

In response to employers' growing concerns, European data protection authorities issued guidance to employers seeking to establish simultaneous compliance with SOX and data protection laws. A February 2006 opinion by the group charged with overseeing implementation of the Directive, Working Party 29 (WP 29), concluded that simultaneous compliance is possible provided certain conditions are met.[7] In its view, while anonymous whistleblowing systems may be justifiable in light of employers' legitimate interest in protecting against fraud and misconduct, that interest is nevertheless subject to a "balance of interests test" in which employers must take into account the privacy interests of employees.

WP 29 continues to wait for an official response from the SEC, but until that moment comes, the prudent employer will reevaluate its whistleblowing system. Employers are encouraged to consider the following compliance measures recommended by data protection authorities:

1. **Creating other Channels of Communication:** Anonymous whistleblowing systems should be complementary to other channels of communication. Anonymous reports should be "the exception to the rule", and employers should encourage employees to identify themselves by ensuring that their identity will be kept confidential.
2. **Adopting Special Handling Procedures:** Where anonymous reports are used, special precautions should be taken, including examining the report as to the appropriateness of its possible circulation and processing anonymous reports with greater speed.
3. **Limiting the System's Scope:** Employers should consider limiting the categories of persons who may report and be reported to those with involvement in financial and accounting matters and limiting complaints that can be reported anonymously to "questionable accounting or auditing matters".
4. **Providing Employees with Adequate Information:** Employees must be informed of the system's existence, functioning, and purpose, possible recipients, and the existence and means of exercising one's rights of access and rectification.
5. **Notifying the Accused:** The accused should be informed as soon as practicably possible of the entity responsible for processing the complaint, the allegations, departments that may receive the report, and the means of exercising rights of access and rectification.

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[6] *See* CNIL Decision 2005-110 of May 26, 2005 (Group McDonald's France); CNIL Decision 2005-111 of May 26, 2005 (Exide Technologies).

[7] Opinion Paper 1/2006, Working Party 29 (February 1, 2006), available at http://ec.europa.eu/justice_home/fsj/privacy/docs/wpdocs/2006/wp117_en.pdf.

6. **Limiting Data Retention Periods:** If unsubstantiated, data should be deleted immediately. Otherwise, it should be retained no more than two months after verification has been completed.
7. **Ensuring Adequate Security and Management:** Employers should take all reasonable technical and organizational steps to ensure data is secure, including establishing a specific organization to handle complaints.

A second compliance issue arises when an employer establishes a system in which complaints will be transferred outside of the EU. Pursuant to the Directive, the transfer of personal data to a country that does not ensure an "adequate level of protection", such as the United States, must be justified. The use of certain model contractual clauses between transferor and transferee or participation in the U.S. Department of Commerce's "safe harbor" program provides such justification.[8] Employers that wish to transfer complaints from Europe to an external service provider outside the EU should ensure that the contract includes provisions providing for confidentiality, limited disclosure of data, compliance with all the rules the employer is subject to, and destruction of the data upon termination of the contract.

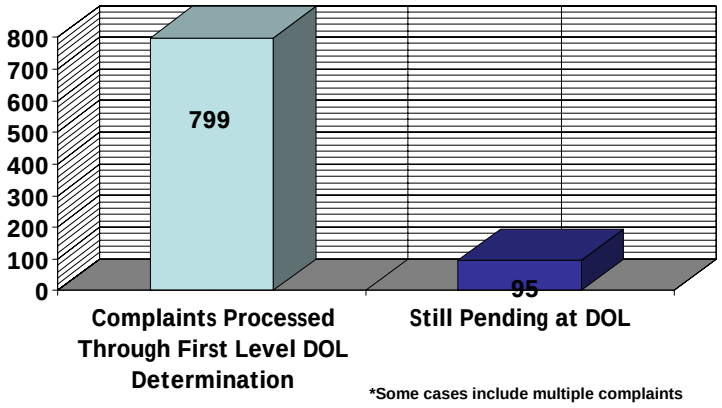
Yet a third compliance issue arises in the guise of national labor and employment law. In November 2005, a German Labor Court of Appeals affirmed a lower court's decision to strike down Wal-Mart's Code of Ethics on the grounds it was not formed in consultation with the works council.[9] Accordingly, companies that either trade their debt or their shares on US stock exchanges operating in Europe will have to carefully examine local labor laws relating to employee representation rights along with data protection laws **before** they implement cross-border codes of ethics.

In sum, companies attempting to comply with Sarbanes-Oxley who implement anonymous hotline procedures and cross-border codes of conduct face legal obstacles and cultural challenges. Careful attention to the requirements of local law should be observed to avoid legal challenges and damage to the company's reputation.

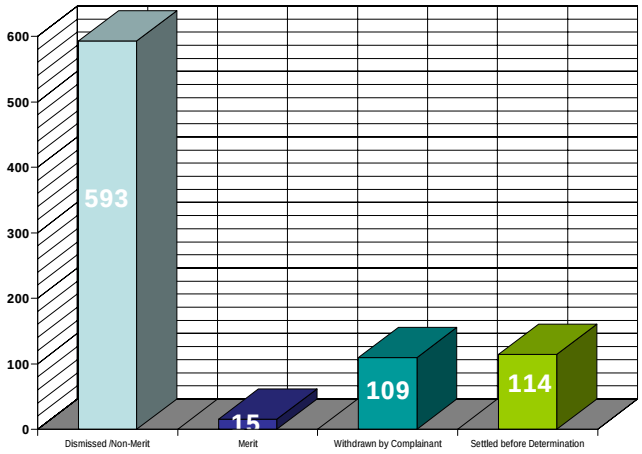
[8] Opinion Paper 1/2006 at 17.

[9] *Wal-Mart Landesarbeitsgericht Rheinland-Pfalz*, Urteil vom 19.01.2005, Az: 10 Sa 820/04.

SOX Whistleblower Cases Filed with DOL (7/30/02—12/31/06): 894*



SOX Whistleblower Complaints: Dep't of Labor Determinations (7/30/02-12/31/06)



Results of Appeals at ALJ Level
7/30/02–1/4/07*

Withdrawn/settled	104
Dismissed with stated intent to be filed in U.S. District Court	54
Untimely	31
SOX not applied retroactively	3
Organization not covered by SOX	32
Other procedural	9
Merit	**6****
No merit	**45**

*** Several cases decided on multiple grounds.**

****Two cases subsequently reversed by ARB.**

Results of Appeals at ARB Level
7/30/02–1/4/07

Withdrawn/settled	3
Dismissed with stated intent to be filed in U.S. District Court	4
Untimely	7
Failure to prosecute	3
Merit	**0**
No merit	**8**