Morgan Lewis

Recent Developments Under SOX and Dodd-Frank Whistleblower Programs

November 18, 2011

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Overview

- Between Dodd-Frank amendments to SOX, and recent case law under SOX issued by the Administrative Review Board (ARB), the scope of SOX civil whistleblower protections has broadened:
  - Interpretations of SOX-protected activity;
  - Standards for adverse action;
  - Standards for pre-hearing dismissal of SOX claims before DOL ALJ;
  - Entities covered by SOX.

Recent Developments: ARB Decision in *Brown*

- *Brown v. Lockheed Martin Corp.*, ARB Case No. 10-050 (Feb. 28, 2011).
  - Affirmed ALJ decision that complainant engaged in protected conduct under SOX due to reasonable belief of mail and wire fraud.
  - No requirement of fraud against shareholders.
  - Complainant ordered reinstated.
- Elements of Mail or Wire Fraud (18 U.S.C. §§1341, 1343):
  - Scheme or artifice to defraud, or to obtain money or property by means of false or fraudulent pretenses, representations, or promises;
  - Specific intent to defraud;
  - Use of U.S. mail or wire communication in interstate commerce in furtherance of scheme.

Recent Developments: ARB Decision in *Brown*

- Protected conduct in *Brown*:
  - Allegation that wrongdoer mailed letters to solicit prospective paramours;
  - Allegation that billing occurred by mail or wire of items to the U.S. government as part of the company' s pen pal program;
  - Allegation that wrongdoer sent sex toys to a soldier in Iraq as part of the Pen Pal program.
- ARB affirmed finding of constructive discharge.

Recent Developments: ARB Decision in *Sylvester*

- *Sylvester v. Parexel International LLC*, 2007-SOX-39, 2007-SOX-42 (ARB May 25, 2011).
  - En banc decision by the Obama Administration's newly appointed ARB
  - Erodes employer-friendly precedents under SOX
  - "SOX claims are rarely suited for Rule 12 dismissals"
  - Complainants do not need to demonstrate that their complaints "definitively and specifically" relate to a SOX-enumerated violation
  - SOX complaints do not need to relate to shareholder fraud
  - Complainants do not need to plead or prove the elements of fraud to prove a reasonable belief of a SOX-enumerated violation

Recent Developments: ARB Decision in *Funke*

- *Funke v. Federal Express Corp.*, ARB Case No. 09-004 (July 8, 2011).
  - FedEx courier suspected that a customer was using FedEx as a conduit to commit mail fraud
  - Courier complained to dispatcher and received no response
  - Courier then reported to local sheriff
  - FedEx terminated employee for allegedly "open[ing] FedEx up to civil and criminal liability"

Recent Developments: ARB Decision in *Funke*

- *Funke v. Federal Express Corp.*, ARB Case No. 09-004 (July 8, 2011).
  - SOX protections apply where employee complains about third party conduct, not just conduct of employer
  - Complainants do not need to report to supervisors; they may report to anyone with "authority to investigate, discover, or terminate misconduct" (quoting 18 U.S.C. §§1514A (a)(1)(c))
  - Complaints to local law enforcement, not only federal law enforcement, are covered
  - Complaints about mail fraud are covered by SOX, and SOX complaints do not need to relate to fraud against shareholders

Recent Developments: ARB Decision in *Menendez*

- *Menendez v. Halliburton, Inc.*, ARB Case No. 09-002, 003 (Sept. 13, 2011).
  - Employee raised accounting concerns internally, filed confidential allegations with SEC, and submitted an email internally to audit committee
  - AGC forwarded email to audit committee, as well as to GC and CFO, who forwarded to employee's supervisor (who was the CAO)
  - SEC notified GC that it was opening an investigation; GC issued a document retention email identifying employee, which was forwarded to the employee's supervisor and co-workers
  - SEC notified company that no enforcement action would be taken, and no accounting changes were made
  - After being put on paid administrative leave, employee resigned

Recent Developments: ARB Decision in *Menendez*

- *Menendez v. Halliburton, Inc.*, ARB Case No. 09-002, 003 (Sept 13, 2011).
  - ARB ruled that the scope of adverse action under SOX is broader than Title VII retaliation protections and *Burlington Northern & Santa Fe R.R. v. White*
  - SOX covers all "unfavorable employment actions that are more than trivial," either alone or in combination with other deliberate employer actions
  - Disclosure of employee's identity contrary to SOX Section 301 (requirement for companies to establish procedures for confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters) was actionable adverse action under SOX
  - ARB affirmed finding of no constructive discharge by resignation after six months of paid administrative leave without ever returning to work

Practical Implications of Case Law Developments

- Recognizing SOX protected conduct:
  - Consider mail and wire fraud
  - Consider protected status of employee who takes confidential documents or information
  - Reports to agencies other than SEC or federal criminal authorities
  - Cf. Tides v. Boeing, 644 F.3d 809 (9th Cir. 2011), cert. denied, where court held that SOX whistleblower provisions do not protect employees who release confidential information to the media.
- Understanding SOX adverse actions:
  - According to ARB, anything more than trivial

Practical Implications of Case Law Developments

- Consider scope and enforcement of confidentiality agreements/policies in light of competing interests
  - Company's interest in protecting confidential information, and importance of policies to taking action against employees who violate them
  - SEC warnings on enforcement of confidentiality agreements/policies on those who may be reporting to the SEC

Recent Developments Under Dodd-Frank

- *Egan v. TradingScreen, Inc.*, Case No. 10-cv-8202, 2011 U.S. Dist. LEXIS 103416 (S.D.N.Y. Sept. 12, 2011).
  - First federal case to interpret the anti-retaliation provisions of § 922 of Dodd-Frank
  - Interpreted § 922 very broadly

Recent Developments – Cases Under Dodd-Frank

- Egan alleged that he provided information regarding corporate fraud to Latham & Watkins, a law firm hired by the board of directors
- Egan was fired, and he then sued for protection under the Dodd-Frank anti-retaliation provisions
  - Defendants argued that because Egan did not report to the SEC, he was not a "whistleblower" under Dodd-Frank
  - Egan argued that he reported "jointly" with Latham
  - Egan further argued that reporting to the SEC was not required, because SEC WP protect reports that are themselves protected by SOX, the Securities and Exchange Act, 18 U.S.C. §1513(e), and any other statute under the SEC's jurisdiction

Recent Developments – Cases Under Dodd-Frank

- Court found that Dodd-Frank is internally contradictory:
  - It defines "whistleblower" as one who reports to the SEC
  - It also appears to protect whistleblower reports that are not required to be made to the SEC
- Court held that there is a narrow exception to the definition of "whistleblower" for disclosures "required or protected" under:
  - SOX;
  - Securities Exchange Act;
  - 18 U.S.C. §1513(e); or
  - Other laws subject to the SEC's jurisdiction
- Such reports are protected, even if they are not made to the SEC

Recent Developments – Cases Under Dodd-Frank

- Court held that because Egan initiated the inquiry into the fraud, and because he provided information to Latham, he would meet the definition of "whistleblower" by providing informaiton "jointly" if Latham in fact reported to the SEC
  - Court further held that such an expansive definition does not apply to the bounty provision
- Court rejected Egan's claim that his reports were protected by SOX, 18 U.S.C. §1513(e), or FINRA rules
- Court required Egan to replead with facts showing that Latham did in fact report such malfeasance to the SEC

Recent Developments – Cases Under Dodd-Frank

- After re-pleading and additional motions, the court dismissed Egan's complaint, with prejudice, on September 12, 2011.
- Court found that Egan had not alleged with specificity any facts that support "knowledge of actual transmission to the SEC."
  - Egan's suggested inferences that the information was transmitted to the SEC were insufficient.
- Implications of *Egan*:
  - Under certain circumstances, the Egan court held that an employee whose internal report causes the company to retain counsel, and who provides information to such counsel, can be a whistleblower if the outside counsel reports such information to the SEC.

Recent Developments – Cases Under Dodd-Frank

- *Pezza v. Investors Capital Corp.*, 2011 U.S. Dist. LEXIS 20038 (D. Mass. Mar. 1, 2011):
  - Dodd-Frank amendment to SOX precluding predispute arbitration agreements applies to arbitration agreements entered into before the enactment of Dodd-Frank

OSHA Releases Interim Final Rule Governing SOX Whistleblower Complaints

- Published Nov. 3, 2011:
  - OSHA announced that changes are designed to incorporate substantive changes made by Dodd-Frank, improve procedures for handling SOX whistleblower complaints, and make SOX whistleblower regulations more consistent with OSHA's rules for administering other whistleblower programs
- Takes effect immediately, but interested parties will be able to comment before the agency issues permanent final regulations.
- Comments must be received by January 3, 2012.

Highlights of Proposed Rules – Changes Based on Dodd-Frank Amendments

- Extends SOL for filing complaints from 90 days to 180 days
- Subsidiaries and affiliates whose financial information is included in the consolidated financials of a covered company are also covered
- Expressly covers employees of nationally recognized statistical rating organizations
- Provides right to jury trials in federal district court if Secretary of Labor does not issue a final order within 180 days of filing of complaint

Highlights of Proposed Rules - Changes to Improve Complaint-Filing Process

- Complaints may be filed orally or in writing, in any language; no particular format is required.
  - Preamble states that this is consistent with ARB's decision in *Sylvester*, noting that ARB held there that federal court pleading standards established in *Twombly* do not apply to SOX complaints.
- Any information provided by respondent at any stage of the investigation must be shared with complainant, and the complainant will be given opportunity to respond.
  - No reciprocal right given to the employer.
- Provides that complainant must prove by a **"preponderance of the evidence"** that his protected activity contributed to the adverse action.
  - Lower burden than "clear and convincing evidence" standard by which employer must establish its defense.

Highlights of Proposed Rules - Broader Relief Available for Whistleblowers

- Rules omit statement in prior regulations that reinstatement would not be appropriate where the respondent establishes that the complainant is a security risk.
- In appropriate circumstances OSHA may order "economic reinstatement" in lieu of the typical preliminary reinstatement.
  - Employer does not have right to choose economic reinstatement.
  - Employer cannot recover costs of economically reinstating an employee should employer ultimately prevail.
- Backpay interest compounded daily rather than quarterly.
- Respondent may file motion to stay enforcement of preliminary reinstatement order pending *de novo* review and hearing before ALJ, but motion will be granted only in "exceptional circumstances," *i.e.*, where respondent can establish necessary criteria for equitable injunctive relief (irreparable injury, likelihood of success on merits, and if balancing of possible harms to the parties and public favors a stay).

Highlights of Proposed Rules – Adverse Action

- Defines adverse action to expressly include “intimidating, threatening, restraining, coercing, blacklisting, or disciplining” an employee

Highlights of Proposed Rules

- Clarification re: "Kick-Out" Provision:
  - Complainant may not initiate an action in federal court after the Secretary of Labor issues a final decision, even if the date of the final decision is more than 180 days after the filing of the complaint.

Thank You!

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