

# Blowing the Whistle on Accounting Fraud: The Sarbanes-Oxley Whistleblower Protections Act At A Glance

A White Paper for Finance Professionals  
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In response to the accounting scandals at Enron and Worldcom that caused huge losses to shareholders and spawned a crisis in investor confidence, the U.S. Congress passed the Sarbanes-Oxley Act in 2002. “SOX,” as it is popularly known, requires publicly traded companies to make certifications about their financial conditions, and imposes stiff penalties on companies and their officers for misrepresenting their finances to shareholders and would-be investors.

The new law also contained protections for accountants and other finance employees who would serve as the front-line protectors of financial integrity and reporting. Modeled after the whistleblower provisions in federal nuclear and environmental laws, Section 806 of SOX created a new civil action for employees of publicly traded companies who faced retaliation for providing information about, or participating in investigations relating to, what they believed to be violations of securities laws on the part of their employers.

Since Congress passed the Sarbanes-Oxley Act, some 1,000 corporate employees have filed complaints under the law with the U.S. Department of Labor (DOL), which investigates and adjudicates whistleblower claims. Although DOL has dismissed the majority of these cases, a significant number have resulted in settlements between whistleblowers and companies. The following overview gives finance professionals some of the information they need to know before blowing the whistle on corporate wrongdoing.

## ***Which Employees are Protected by SOX?***

SOX protects employees of publicly traded companies and their subcontractors. The definition of “employee” is broad under the statute, and generally includes present and former workers, supervisors, managers, officers, and even independent contractors. Former employees are protected when their protected activity occurs during the course of their employment. SOX’s protection of independent contractors depends on the degree to which the publicly traded

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company exerts control over the contractor's work. For instance, if the independent contractor reports to company superiors on a daily basis, is given a specific list of daily contacts and appointments, has little or no control over hours or schedule and is required to complete most or all work at the company's offices, SOX protects the contractor from retaliation for providing information about violation of federal securities and fraud laws.

### ***Which Employers are Covered?***

SOX whistleblower provisions apply to publicly traded companies that are subject to the registration or reporting requirements of the Securities Exchange Act. This includes foreign corporations doing business in the U.S., but the law does not protect employees working outside of the U.S., even if they work for a U.S. company.

SOX whistleblower protections extend to private companies that serve as agents or contractors of publicly traded companies, and may also cover subsidiaries. Subsidiaries of public companies may be held liable if, for example, they are mere instrumentalities of the parent company, share common management and operations with the parent company, or are agents of the parent company in retaliating against a whistleblower. The law assigns liability not only to companies, but also to the individual(s) who have spearheaded the retaliation against a complaining employee.

### ***What Does the Whistleblower Have to Prove?***

There are three central elements to a SOX claim:

- 1) the employee is engaged in protected activity;
- 2) the employer took adverse employment action against the employee; and
- 3) the adverse employment action against the employee was caused at least in part by the protected activity.

### ***What is Protected Activity?***

An employee engages in "protected activity" when he or she complains -- internally or to regulators, and maybe even to the media -- that the company has violated a federal rule or law relating to fraud on shareholders. An employee is protected only for raising possible violations of federal laws, so if an employee complains about violations of state regulations, without reference to possible federal law violations, the employee will not be protected by SOX. Despite this narrow definition, SOX insulates an employee from retaliation for a wide range of protected conduct, from simply performing auditing duties to contacting the news media about possible shareholder fraud.

It is critical that finance professionals remember that an employee is protected by SOX only when he or she points to potential fraud against shareholders in violation of the law, and not when the employee merely make general inquiries about the company's financial losses or errors.

An employee's complaint about the company's violations of its own internal policies and ethical standards, or even its failure to follow GAAP, does not fall under the SOX whistleblower protections. At the heart of protected allegations is that the conduct violated the law and would have a negative impact on shareholders and investors. So while it's understandable that a well-intentioned employee might disagree with a company's investment decisions or audit procedures, raising such disagreements might leave the employee unprotected by SOX unless the employee reasonably believes and suggests that these practices are illegal under federal securities and fraud laws.

While the employee must reasonably believe the employer is engaged in fraud or a violation of securities laws, however, he or she need not be right in that belief. As long as the employee's belief is reasonable, the employer cannot retaliate against the employee for speaking out, even if the belief ultimately proves to be wrong.

### ***When Does an Employee Suffer an Adverse Employment Action?***

SOX prohibits an employer from taking "adverse employment action" against an employee for engaging in protected activity. To the extent that the DOL adopts the standard that the U.S. Supreme Court has established in a similar context, the DOL will consider an action "materially adverse" if it would dissuade a reasonable finance professional from raising concerns about practices that he or she believes to constitute fraud on shareholders. This would certainly include firings, demotions, cuts in pay or denial of promotions, but it can also include reassignment of job duties and responsibilities, assignment of undesirable shifts, harassment, micromanagement, excessive supervision, or exclusion from important company activities.

### ***Was the Adverse Employment Action Causally Related to the Protected Activity?***

In order to prove a SOX whistleblower claim, the employee need only show that the protected activity was a "contributing factor" in the employer's decision to take adverse action against the employee. The whistleblower's protected activity does not have to be the employer's sole reason or even a significant reason for the adverse action, but only has to play some role in the employer's decision, however minor.

Employees bringing actions under SOX may satisfy the "contributing factor" standard in either of two ways. In rare cases, the employee may be able to present what is called "direct evidence," such as the fact that the supervisor warned the employee that reporting possible fraud to securities regulators would result in termination. More often the employee will have to prove his or her case through circumstantial evidence, which may include the close timing between the protected activity and the adverse action, the fact that the employer has purportedly fired the employee based on conduct for which it has not disciplined other employees, the employer's history of retaliating against whistleblowers, or even the fact that the employer has failed to comply with its own procedures or has presented false reasons for its actions.

### ***Procedures for Filing a SOX Whistleblower Claims***

In order to pursue a SOX whistleblower claim, an employee must file a written complaint with any office of the Occupational Safety and Health Administration (“OSHA”), which is part of DOL, within 90 days of the retaliatory action. OSHA will conduct an investigation if it determines that the complaint contains the necessary elements of a claim, and will eventually issue a preliminary determination.

Based on the record of OSHA investigators to date, an employee should not expect OSHA to find in his or her favor, and should plan instead on requesting a hearing before an Administrative Law Judge, which the employee must do within 30 days of receiving a negative determination from OSHA. The proceedings that follow are very similar to those in any court, and the employee may even withdraw his or her complaint from the DOL proceedings and file a case in federal court if the DOL fails (as it almost always does) to issue a final decision within 180 days of the date the employee first filed a complaint with OSHA. In either forum, the employee can engage in the full range of pre-trial discovery that is part of civil lawsuits, including obtaining relevant documents from the employer and taking depositions of the key decision-makers and other witnesses.

While employers have won the majority of the cases actually decided so far by DOL judges at trial, a large number of SOX whistleblower cases have also been resolved before trial, presumably with the employee walking away with an acceptable settlement amount. The willingness of publicly traded companies to settle SOX whistleblower complaints is not hard to understand. Regardless of which side would ultimately prevail in a DOL hearing, where the complaining employee would have to prove all elements of his or her SOX claim in order to win, the employee's allegations of fraud on shareholders can place the employer at serious risk of shareholder lawsuits and regulatory scrutiny. If the employee's allegations are well-founded, many companies would rather settle a case quickly than run the risk of attracting prolonged attention to their financial practices.

### ***What Remedies are Available to Successful Whistleblowers?***

The Sarbanes-Oxley Act entitles employees who prevail on their whistleblower claims to a full “make whole” remedy, which includes reinstatement and can include back pay and benefits, “front pay” for lost wages going forward, and compensatory damages for emotional pain and suffering. Employees who prevail in such proceedings may also recover their litigation costs, including attorneys’ fees.

### ***How Do I Decide Whether and How to Report Unlawful Conduct?***

Whether to report apparent fraud on shareholders or violations of federal securities laws – and, if so, when, how and to whom – can be a very difficult decision for a finance professional, as blowing the whistle on an employer's unlawful activity can be a career-ending move. Even so, a strong sense of duty to shareholders and an awareness of up-the-ladder reporting

requirements compel many finance professionals to speak out about unlawful activities every year.

While the decision to blow the whistle on corporate wrongdoing should not be taken lightly, and should be made only after seeking competent legal advice, the fact is that a large number of finance professionals have spoken out and then achieved great outcomes when challenging their employers' retaliation. The Sarbanes-Oxley Act provides strong protections for employees, and there exist today a number of non-profit organizations that stand ready to support workers who blow the whistle on unlawful activity. The contact information for these groups, as well as other helpful information for would-be whistleblowers, can be found on the Katz, Marshall & Banks website at <http://www.kmblegal.com/links.php>.