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DOL ADMINISTRATIVE CASE INTERPRETS SARBANES-OXLEY WHISTLEBLOWER PROTECTION PROVISIONS

[17511] May 12, 2004 TO: ACCOUNTING/TREASURERS MEMBERS No. 22-04 COMPLIANCE ADVISORY COMMITTEE No. 49-04 INTERNAL AUDIT ADVISORY COMMITTEE No. 7-04 SEC RULES MEMBERS No. 68-04 RE: DOL ADMINISTRATIVE CASE INTERPRETS SARBANES-OXLEY WHISTLEBLOWER PROTECTION PROVISIONS A recent ruling by an administrative law judge (ALJ) of the Department of Labor sheds light on various issues arising under the whistleblower protection provisions in the Sarbanes- Oxley Act (the "Act").1 Although the case involves a bank, the issues it raises may have applicability for other issuers of securities subject to the Act.2 These issues include the burden of proof for whistleblowers and an employee's right to have a personal attorney present during meetings conducted as part of an internal investigation. Each of these issues is discussed in more detail below. FACTS OF THE CASE The complainant in this case was the Chief Financial Officer (CFO) at a bank holding company subject to the Act. In 2002, he was suspended and then terminated from his position by the bank. In the months before his termination, he had alleged that the bank's chief 1 See Welch v. Cardinal Bankshares Corp. DOL ALJ No. 2003-SOX-15 (Jan. 28, 2004) (the "ALJ's Decision"). A copy of the ALJ's decision is available on the Department of Labor's website at: http://www.oalj.dol.gov/public/wblower/decsn/03sox15c.htm. (Cites in this memorandum to the ALJ's Decision are to the webpage numbers.) 2 The whistleblower provisions of the Act are found in Section 806 of the Corporate and Criminal Fraud Accountability Act of 2002, which is Title VII of the Act (18 USC 1514A). They apply to any company that either has a class of securities registered under Section 12 of the Securities Exchange Act of 1934 or that is required to file reports under Section 15(d) of the Exchange Act, or any officer, employee, contractor, subcontractor, or agent of such company. In particular, Section 806 prohibits the persons covered by its provisions from discharging, demoting, suspending, threatening, harassing, or discriminating against an employee in the terms of conditions of such person's employment because of any lawful act done by the employee to provide information to or assist in an investigation of conduct the employee reasonably believes would violate 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 a Federal regulatory or law enforcement agency, any member or committee of Congress, or a 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. 2 executive officer had engaged in insider trading, that the bank had overstated its income in public documents, and that the bank had restricted the CFO from meeting with the bank's

external auditors. As a result of his concerns with the bank's accounting practices and its lack of controls, he had refused to sign two of the certification forms required by the Act. In response to the CFO's concerns, the bank's audit committee asked the bank's outside counsel and outside auditor to investigate the CFO's allegations. Because the CFO thought that the bank was planning to terminate him for raising his concerns, he refused to meet with the bank's outside counsel and auditor unless he could have his personal attorney present. In response to this demand, the CFO was suspended and subsequently fired for insubordination – i.e., refusing to assist the bank in its investigation. Upon his termination, the CFO commenced an administrative proceeding against the bank claiming wrongful termination under the whistleblower provisions of the Act. In considering the CFO's claims of wrongful termination, the ALJ did not consider the whether the bank had actually violated, or intended to violate, any federal fraud statute or SEC rules or regulations that would trigger reporting under the Act. Instead, the ALJ's sole focus was whether the bank had violated the whistleblower prohibitions in the Act. A WHISTLEBLOWER'S BURDEN OF PROOF According to the ALJ's decision, to prevail in a whistleblower case, a complainant must establish by a preponderance of the evidence that: (1) he engaged in protected activity as defined by the Act; (2) his employer was aware of the protected activity; (3) he suffered an adverse employment action; and (4) circumstances exist that are sufficient to raise an inference that the protected action was likely a contributing factor in the unfavorable action.3 Significantly, the ALJ found that, as used in element (4), the term "contributing factor" means "any factor which, alone or in connection with other factors, tends to affect in any way the outcome of the decision" – it does not require that the protected activity be "a 'significant,' 'motivating,' 'substantial,' or 'predominant' factor in a personnel action . . ."4 A respondent may, however, avoid liability under this provision of the Act "by producing sufficient evidence to clearly and convincingly demonstrate a legitimate purpose or motive for the adverse personnel action."5 With respect to the facts presented, the ALJ found that the CFO had satisfied his burden of proof based on the ALJ's findings that: the CFO engaged in activities protected by the Act;6 some or all of the bank's top management were clearly aware of the CFO's protected activities; the CFO suffered an unfavorable personnel action (his suspension and subsequent termination); and the CFO's activity was a "contributing factor" in the unfavorable personnel action. With respect to this last issue, the ALJ noted, in part, "that proximity in time between [the CFO's] 3 ALJ's Decision at p. 49. 4 Id. (citing Marano v. Dept. of Justice, 2 F.3d 1137 (Fed. Cir. 1993) interpreting the Federal Whistleblower Protection Act, 5 USC 1221(e)(1)). 5 Id. 6 The ALJ found that the CFO had a reasonable belief that violations were being committed and that his activities relating to bringing these matters to light thus constituted "protected activity." 3 protected activity and the adverse action is itself sufficient to create an inference of unlawful discrimination."7 A WHISTLEBLOWER'S RIGHT TO PERSONAL COUNSEL After finding that the CFO had met his burden of proof, the ALJ turned to the issue of whether the bank had demonstrated by clear and convincing evidence that it would have taken the unfavorable personnel action irrespective of the CFO having engaged in protected activity. Because the reason stated by the bank for suspending and then dismissing the CFO was the CFO's refusal to meet with the Respondent's outside counsel and auditor without his attorney present, the ALJ next considered the CFO's right to counsel both as a general matter and under the facts of the case. The bank argued that general employment law principles establish that the CFO could have been discharged for even consulting with counsel on matters related to the CFO's duties at the bank because the presence of the CFO's counsel during an interview conducted during the bank's investigation would destroy any privilege that might attach to the investigation. The ALJ found that the general employment law principles cited by the bank had no application to the case before the ALJ because the purpose of the meeting arranged by the bank's outside

counsel and auditor “was not to conduct a legitimate inquiry,” but rather, to “create a situation whereby the [CFO] would not attend the meeting so [the bank] could use that as a justification for terminating [the CFO’s] employment.”8 The ALJ next considered the CFO’s right to counsel under the circumstances presented by the case. The ALJ did not find persuasive the bank’s argument that the bank was justified in taking an adverse action against the CFO based upon the CFO’s insistence that his counsel be present during the CFO’s interview by the bank’s outside auditor and counsel because: • The sole purpose of the meeting between the CFO and the bank’s outside counsel and auditor during the course of their investigation was to elicit information from the CFO. As such, the information that would be disclosed would be information already known to the CFO and his counsel; • As a fiduciary of the bank, the CFO had a duty to maintain the confidentiality of any proprietary information he learned in the performance of his duties. Any attorney the CFO retained under these circumstances would similarly be under a duty to maintain the confidentiality whether the information came from the CFO directly or through the bank’s investigation at a meeting at which the CFO’s attorney was present; • The information to be discussed at the meeting (e.g., allegations of untrue or misleading statements of material fact regarding the company’s financial condition, the absence of adequate internal controls, allegations of insider trading) was “precisely the type of 7 ALJ’s Decision at p. 58. The ALJ’s Decision provides more support for this finding: “Even without the inference of unlawful discrimination based on timing, [the bank’s] explanation of its actions does not ring true. [The bank]argues that [the CFO] was suspended and later discharged solely because he refused to meet with [the bank’s investigators (i.e., its outside auditor and counsel)] without a personal attorney. . . . The events . . . establish that [the CFO] became the subject of an adverse and discriminatory employment action well before he refused to meet with [the bank’s investigators] without his personal attorney (and even before any investigation into [his] complaints had taken place). Thus, his subsequent ‘insubordination’ was a mere pretext for his eventual termination.” ALJ Decision at pp. 58-59. 8 ALJ Decision at p. 62. 4 information which must be disclosed under Sarbanes-Oxley, either to the Federal government or the corporation’s management;”9 and • Under case law, the communications made by or to the bank’s attorney in the presence of the CFO would not be protected by the attorney-client privilege from disclosure to the CFO’s attorney.10 Accordingly, according to the ALJ’s Decision, the bank did not demonstrate by clear and convincing evidence11 that it would have suspended or terminated the CFO irrespective of the CFO having engaged in activity protected under the Act. THE ALJ’S HOLDING AND ORDER After considering the totality of the evidence, the ALJ found that the CFO had demonstrated by a preponderance of the evidence that he was fired by bank because he complied with his duty to disclose information governed by the Act. Based on this finding and consistent with the relief set forth in the Act, the ALJ ordered the bank to: reinstate the CFO to his former position as CFO without loss of seniority and loss of any benefits to which he was entitled prior to his discharge; pay to the CFO his back pay with interest at the statutory rate; and pay to the CFO all costs and expenses, including attorney fees, reasonably incurred by him in connection with the proceeding. Tamara K. Salmon Senior Associate Counsel 9 ALJ Decision at p. 63. 10 This last finding was based on the following holding in Amatuzio v. Gandalf Systems Corp., 932 F. Supp. 113, 118 (1996): “Communications with a corporation’s attorney made by, to, or in the presence of a non-attorney employee who later becomes adverse to the corporation are not protected by . . . the attorney-client privilege from disclosure by the former employee to his litigation counsel if: (i) the litigation involves an allegation by the employee that the corporation breached a statutory or common law duty which it owed to the employee, (ii) the communication disclosed involves or relates to the subject matter of the litigation; and (iii) the employee was not responsible for managing the litigation or making the corporate

decision which led to the litigation. We also see no reason why a similar rule would not apply with respect to disputes that have not yet resulted in litigation." ALJ Decision at pp. 63-64. 11 According to the ALJ's Decision, a "clear and convincing" standard "is higher than a preponderance of the evidence and less than beyond a reasonable doubt." ALJ Decision at p. 65.
