

Increased Funding, Revamped SEC Procedures, and Disgruntled Workforce Create Perfect Storm

By Fred Rivera & Javier Garcia

Without question, 2008 and 2009 will go down as two of the more remarkable years in the history of the country's economy—Wall Street powerhouses shuttered or sold-off, the collapse of the subprime and real estate markets, federal bailouts, mass layoffs, and the discovery of a Ponzi scheme that bilked trusting investors out of \$65 billion. Less than a decade after Enron and the passage of the Sarbanes-Oxley Act of 2002, the public's trust in corporate accountability and the government's ability to regulate financial systems is at an all-time low. Employees, investors, the media, and the general public now take a jaundiced view of many normal and customary business practices, such as executive bonuses, employee reward programs, and business-development events. It is therefore no surprise that the government and individuals have reacted with increased vigilance over our financial system. One concrete consequence, which is noticeable in new legislation, government spending, and federal agency enforcement priorities, is an increased emphasis on the importance of whistleblowers in the corporate and government compliance environment.

On the whistleblower menu for 2009 and beyond: new whistleblower protection laws included in the Stimulus Bill of 2009; revamped SEC procedures following the agency's failure to detect Bernard Madoff's \$65 billion fraud scheme; a new "Office of the Whistleblower" at the Financial Industry Regulatory Authority (FINRA); and increased funding for federal government investigations of Sarbanes-Oxley whistleblower complaints and other fraud matters under the recently passed Fraud Enforcement and Recovery Act of 2009.¹ These efforts, in addition to near record levels of unemployment and a general uneasiness among regulators about the strength of the

financial services sector, will undoubtedly lead to an increase in government investigations and enforcement activity triggered by whistleblower complaints. Now, more than ever, corporations must implement strong whistleblower programs and prepare for the coming onslaught of complaints and investigations.

New Whistleblower Protections in the Stimulus Bill

The American Recovery and Reinvestment Act of 2009² (Recovery Act) has an important provision aimed at encouraging whistleblower activity. The Recovery Act's McCaskill Amendment, Title XV, § 1553, contains a broad provision that provides whistleblower protections to employees of private contractors and state and local governments who report mismanagement, fraud, or any violation of law linked to stimulus funds:

Prohibition of Reprisals: An employee of any non-Federal employer receiving covered funds may not be discharged, demoted, or otherwise discriminated against as a reprisal for disclosing, including a disclosure made in the ordinary course of an employee's duties, to the Board, an inspector general, the Comptroller General, a member of Congress, a State or Federal Regulatory or law enforcement agency, 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), a court or grand jury, the head of a Federal agency, or their representatives, information that the employee reasonably believes is evidence of [misuse of stimulus funds].³

It doesn't take much "reading between the lines" to identify the goal of the McCaskill Amendment: to generate as many

whistleblower tips as possible, which will lead to an increase in government investigations and enforcement actions.

The McCaskill Amendment includes provisions that protect whistleblowers who report fraud or waste and are employed by nonfederal employers that receive funds from the Recovery Act, and potentially by private employers who contract with entities receiving federal stimulus funds. Much like the whistleblower protections contained in Sarbanes-Oxley, covered employers are prohibited from discharging, demoting, or discriminating against an employee who raises concerns of improper spending of stimulus funds.

Also similar to other whistleblower protection statutes, under the Recovery Act, the whistleblower raising a concern does not have to be "right" about his or her belief that a company has engaged in fraud or waste of stimulus funds. Rather, the new law protects employees who report matters that he or she "reasonably believes" evidence:

- gross mismanagement of stimulus funds
- gross waste of stimulus funds
- a substantial and specific danger to public health or safety related to the implementation or use of stimulus funds
- an abuse of authority related to the implementation or use of stimulus funds
- a violation of a law, rule, or regulation that governs an agency contract or grant related to stimulus funds

All employers receiving stimulus funds are required to post the rights and remedies provided to employees under the McCaskill Amendment.⁴ Whistleblowers who believe they have been retaliated against must file a complaint with the appropriate inspector general. Unless the inspector general determines that the complaint is frivolous, does not relate to stimulus funds, or another federal or

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state judicial or administrative agency is addressing the complaint, the inspector general must investigate the complaint and submit a report of the findings to the complainant, employer, and the appropriate agency within 180 days of receiving the complaint.⁵ Within 30 days of receiving an inspector general's investigative findings, the head of the agency shall determine whether there has been a violation.⁶ As practitioners who regularly appear before the Securities and Exchange Commission (SEC) and U.S. Department of Justice know full well, such findings frequently lead to more serious criminal investigations and prosecutions.

The McCaskill Amendment will play a significant role in ensuring transparency and accountability in stimulus fund spending. President Barack Obama has specifically stated that a crucial objective for his administration will be ensuring that stimulus "funds are used for authorized purposes and every step is taken to prevent instances of fraud, waste, error, and abuse."⁷ Indeed, look for the McCaskill Amendment to provide an avenue of enforcement for the Obama administration, as well as another avenue of relief for employees. Ultimately, the broad protections of the McCaskill Amendment, coupled with the wide distribution of stimulus funds, will undoubtedly lead to more federal enforcement activity based on whistleblower complaints and tips.

SEC, FINRA Move to Aggressively Investigate Whistleblower Complaints

The SEC's involvement in the Bernard Madoff tale—and its failure to timely respond to early tips about Madoff's fraud scheme—is now well documented. Harry Markopolos, a researcher at an investment firm competing with Bernard L. Madoff Securities Investments, repeatedly warned the SEC's Boston office about Madoff and his questionable investments.⁸ Between 2000 and 2005, Mr. Markopolos filed five complaints with the SEC concerning Madoff. In one complaint, he tried to garner the SEC's attention by entitling it "The World's Largest Hedge Fund Is A Fraud."⁹ Mr. Markopolos's complaints to the SEC included a report containing 29 specific "red flags" associated

with Madoff's business, and in a Nostradamus-like manner, "he feared Mr. Madoff was running a giant Ponzi scheme."¹⁰ And he was not alone: SEC records show that Mr. Markopolos's complaints were among 12 similar tips the agency received from 2003 to 2006, including a 2005 email from a "concerned investor" stating that "Madoff is running a very sophisticated fraudulent pyramid scheme."¹¹ The SEC took no public action until 2008, and only after Madoff confessed to his sons.

In response to harsh criticism of its handling of whistleblower complaints about Madoff, the SEC is revamping its procedures for handling whistleblower complaints and tips. The SEC has engaged the Center for Enterprise Modernization, a federally funded research and development center, to conduct a thorough review of the agency's internal procedures used to evaluate complaints, tips, and referrals. It is expected that, following this review, the SEC will implement procedures aimed at aggressively investigating all reasonably credible complaints filed with the agency. SEC Chairman Mary Schapiro recently stated, "As we continue to reinvigorate our enforcement efforts as an agency, it's vitally important that we move very aggressively to improve staff's use of tips and complaints from investors and whistleblowers."¹² Indeed, Chairman Schapiro is not waiting for the final report to change how the agency handles whistleblower complaints: In January, she took steps to make it easier for enforcement staff to obtain approval to issue subpoenas based on whistleblower complaints. Regular practitioners before the SEC have noticed a significant increase in SEC subpoena activity since Chairman Schapiro's easing of subpoena-issuance procedures.

According to SEC statements, once the review process is completed, it plans to implement a centralized process to review and act swiftly on whistleblower complaints and other tips. The agency typically receives hundreds of thousands of tips and complaints each year at either its Washington, D.C., headquarters or its 11 regional offices across the country. To date, the agency has lacked any centralized process allowing for systemic review

of whistleblower complaints. The SEC expects that the new process will more effectively identify credible leads for potential enforcement action, in addition to areas of high risk for compliance examinations.

The SEC is also getting pressure from the agency's independent inspector general to make significant changes to the agency's investigation and enforcement programs—changes that will likely improve the effectiveness of its enforcement programs. In September 2009, the SEC Inspector General H. David Kotz released reports concerning the agency's mishandling of the Madoff matter,¹³ as well as a set of recommendations regarding the way the agency evaluates tips, trains investigators, and document examinations.¹⁴ The recommended changes include incorporation of basic investigative techniques, such as recording witness interviews and using a database for tips and complaints. The SEC should also "require tips and complaints to be reviewed by at least two individuals experienced in the subject matter prior to deciding not to take further action," according to Kotz's report recommendations.¹⁵

Not to be outdone, in March FINRA, the largest independent regulator for domestic securities firms, established a new "Office of the Whistleblower." According to its press release, FINRA's whistleblower office will "expedite the review of high-risk tips by FINRA senior staff and ensure a rapid response for information that would merit further investigation." Brokers, investors, and any other individual with information suggesting that potentially illegal or unethical activity is taking place can use the service, said Herb Perone, a spokesman for FINRA. Any whistleblower tips that fall outside the FINRA's jurisdictional reach will be referred to the appropriate regulatory or law enforcement agencies, according to FINRA.

Bottom line: The SEC and FINRA's emphasis on whistleblower complaints and tips can only lead to an increase in the number of new investigations and enforcement actions, potentially up to record numbers. Public and political pressure to pursue corporate wrongdoers will add to the pressure hoisted on the agencies to take prompt and aggressive action.

Expect More Whistleblower Investigations, Findings by OSHA

The Occupational Safety & Health Administration (OSHA), which is the federal agency charged with investigating employee whistleblower claims under Sarbanes-Oxley and 13 other whistleblower statutes, received a 6 percent boost to its enforcement budget for the 2010 fiscal year. The Obama administration requested the additional funds to increase OSHA's ability to "vigorously enforce . . . whistleblower protections."¹⁶ Not coincidentally, the increased funding came on the heels of a report from the Government Office of Accountability (GOA), which found that whistleblowers who call out illegal activities are not adequately protected from retaliation from their employer. The GOA report concluded that such problems resulted largely from a lack of sufficient resources and proper tracking of complaints, as well as a complicated patchwork of regulations intended to protect whistleblowers.¹⁷

According to OSHA's data, of the more than 1,800 whistleblower cases the agency investigated in 2007, 21 percent of all investigations resulted in a favorable outcome for whistleblowers. In addition, approximately half of whistleblower investigators reported to GOA that they lacked necessary resources to properly investigate whistleblower complaints, including basic supplies such as computers, cell phones, and printers. OSHA's increased funding for investigation and enforcement capability will undoubtedly increase the number of agency investigations, and, ultimately, findings favorable to whistleblowers, and shine a bright spotlight on allegations of corporate fraud, waste, and other misconduct.

Whistleblower Protections, Evolving Issues, and Employer Considerations

Courts analyzing whistleblower claims under the Recovery Act's McCaskill Amendment will likely turn to the legal standards that have been developed under section 806 of Sarbanes-Oxley.¹⁸ Because the goals of section 806 and the McCaskill Amendment are similar—protecting from retaliation employees who report fraud—applying similar standards makes good sense and will give employers some

guidance on the new law. Further, both statutes have similar burdens of proof in that they both require an employee to prove that the protected disclosure was a "contributing factor" in the employer's decision to take adverse employment action against the employee.¹⁹ Thus, similar to section 806, an employee filing suit under the McCaskill Amendment will likely have to prove:

1. The employee engaged in protected activity.
2. The employer knew the employee engaged in the protected activity.
3. The employee suffered an unfavorable personnel action.
4. The protected activity was a *contributing factor* in the unfavorable action.²⁰

Under section 806, courts apply an "objective reasonableness" standard to evaluate whether an employee in good faith believed the company engaged in fraud or other misconduct, considering the knowledge available to a person "in the same factual circumstances with the same training and experience. . . ."²¹

Like Sarbanes-Oxley, however, the McCaskill Amendment will also present legal challenges for employers and legal practitioners, including determining what is "protected activity." For example, in today's 24/7 media world, an employee is more likely than ever to report alleged corporate fraud or misconduct to the media. Is reporting to the media protected activity? If the employee's "whistleblowing" to the media includes the disclosure of confidential or proprietary information, can the employer discipline the employee for violating company policy? Moreover, look for more media involvement in whistleblower issues. Just as Michael Moore has done for his most recent film in which he publicly solicited Wall Street whistleblowers to help craft the script,²² and *Time* magazine did when it named whistleblowers Cynthia Cooper of WorldCom, Sherron Watkins of Enron, and Coleen Rowley of the FBI as its "Persons of the Year," whistleblowers will continue to attract popular attention.

Further, it should come as no surprise

that the increased whistleblower protections come with a price tag to employers. The cost of defending a whistleblower investigation or lawsuit, and the accompanying media attention, can be devastating to a company, especially in today's tough economy. Defense costs include investigating the employee's retaliation complaint, defending the complaint at the administrative level, and potentially defending a court suit. Moreover, and perhaps more significant and costly, employers will also need to investigate the underlying substantive fraud or misconduct allegation of the whistleblower. These allegations may include purported accounting improprieties, violations of a multitude of federal or state laws applicable to the company, illegal kickbacks, tax violations, or a host of other wrongdoings offered by the whistleblower. If high-profile, the matter will attract media attention, adding yet another layer of complexity and risk to the equation.

Adding to the legal and financial challenges, legal scholars are proposing and advocating for broader protections for whistleblowers. As whistleblower laws develop, advocates are proposing more flexible reporting requirements that expand protected activity to cover virtually all disclosures:

First, a whistleblower should receive protection for internal reports to supervisors *or* external reports to a government body so long as the employee reasonably believes that the report recipient can remedy the alleged wrongdoing. . . . Second, employees who report wrongdoing to the media or third party advocacy groups should receive protection if they can show that both an internal and external report would have been ineffective. Third, legislators should protect an employee who reports wrongdoing via the Internet if the employee has tried other channels to no avail, the employee reasonably believes that his or her posting will reach a recipient who can resolve the issue, and the employer is actually violating the law.²³

As can be imagined, all these evolving issues and challenges make whistleblower laws and regulations extremely difficult and complicated for employers to anticipate and manage. A good example of how these new whistleblower protections, coupled with the struggling economy and a disgruntled workforce, may create the “perfect storm” is illustrated in the recent decision of *Harp v. Charter Communications*.²⁴ In *Harp*, a laid-off employee filed suit under Sarbanes-Oxley’s whistleblower protections, alleging that her discharge was retaliation for reporting shareholder fraud. The plaintiff claimed that she was discharged after reporting that payments were being authorized to a contractor for work that was not performed.

Although the court dismissed the case based on its finding that the employee did not have an objectively reasonable belief that fraud had occurred, the dissent persuasively identified several points that it contended could have swayed a jury to find the company retaliated against the employee. Specifically, the dissent highlighted facts that undermined the employer’s case, such as comments from a human resources manager to the plaintiff that her allegations of fraud would be investigated and “its going to get ugly”; and further noting that the reduction in force of the entire auditing department could be seen as an easy way for the company to eliminate the “pesky unit” that uncovered the problem. As the dissent clearly illustrates, reasonable people can formulate different inferences from facts, and ultimately differ as to the merits of whistleblower claims. These differences of opinion and uncertainty are what make whistleblower claims extremely difficult to anticipate when making employment decisions, and ultimately, difficult to defend.

The new whistleblower protections, and challenges arising from them, and existing whistleblower protection statutes make it all the more important for employers to have the appropriate policies and procedures in place for responding to whistleblowers and their allegations. Employers have to be prepared to adequately investigate allegations and ensure that no one within the company or organization takes any action that might be considered retaliatory. The failure to have a respon-

sive plan or system in place can be a costly mistake.

What to Expect . . . More Complaints, More Enforcement

Since the passage of Sarbanes-Oxley, whistleblower complaints and tips have dramatically altered the corporate accountability landscape. Employees emboldened by the protections offered by whistleblower statutes have more freely lodged complaints asserting a variety of perceived corporate malfeasance. For many, the events of the past year have more clearly than ever highlighted how important it is that employee complaints and other tips be taken seriously by government enforcement agencies. And these beliefs are supported by empirical data: According to the 2008 Association of Certified Fraud Examiners’ *Report to the Nation*, occupational fraud in corporate environments is most frequently discovered as a result of whistleblower complaints or tips.²⁵ The federal government’s recent actions to add new whistleblower protections, increased funding, and revamped processes will undoubtedly increase the pace of complaints, tips, and ultimately, enforcement activity by federal agencies.

Endnotes

1. Pub. L. No. 111-21.
2. Pub. L. No. 111-5.
3. *Id.* at § 1553(a).
4. *Id.* at § 1553(e).
5. *Id.* at § 1553(b)(2)(A)(i)-(ii).
6. *Id.* at § 1553(c)(2).
7. Susan Berger & Barrie Tabin, *Accountability and Transparency in the American Recovery and Reinvestment Act*, ENTREPRENEUR, June 2009 (available at www.entrepreneur.com/tradejournals/article/202073030.html).
8. Sarah N. Lynch, *SEC Moves to Review Whistleblower Complaints*, WALL ST. J., March 5, 2009 (available at <http://online.wsj.com/article/SB123627112950241429.html>).
9. Ross Kerber, *The Whistleblower: Dogged Pursuer of Madoff Wary of Fame*, BOSTON GLOBE, January 8, 2009 (available at www.boston.com/business/articles/2009/01/08/the_whistleblower?mode=PF).
10. Lynch, *supra* Note 8.
11. Kevin McCoy, *Madoff Case Spurs SEC to*

Revamp Whistleblower Policy, USA TODAY, March 5, 2009 (available at www.usatoday.com/money/markets/2009-03-05-madoff-sec-whistle-blower-complaints_N.htm).

12. Lynch, *supra* Note 8.

13. U.S. Securities and Exchange Commission Office of Inspector General, Office of Investigations, *Investigation of Failure of the SEC to Uncover Bernard Madoff’s Ponzi Scheme (Public Version)* (August 31, 2009) (available at www.sec.gov/news/studies/2009/oig-509.pdf).

14. U.S. Securities and Exchange Commission Office of Inspector General, Office of Audits, *Program Improvements Needed Within the SEC’s Division of Enforcement* (September 29, 2009) (available at www.sec-oig.gov/Reports/AuditsInspections/2009/467.pdf).

15. *Id.*

16. Tom Starnier, *Obama’s Budget Priorities*, HUMAN RESOURCES EXECUTIVE ONLINE, March 9, 2009, (available at www.hreonline.com/HRE/story.jsp?storyId=185020230).

17. U.S. Government Accountability Office, *Whistleblower Protection Program—Better Data and Improved Oversight Would Help Ensure Program Quality and Consistency* (January 2009).

18. 18 U.S.C. § 1514A

19. Compare 29 C.F.R. § 1980.104(b)(1)(iv) (under Sarbanes-Oxley, a complainant establishes a prima facie case by showing that “protected activity was a contributing factor in the unfavorable action”) with section 1553(c)(1)(A)(i) (under the McCaskill Amendment, a person alleging reprisal for protected disclosures must show that the disclosure was a “contributing factor in the reprisal”) (emphasis added).

20. 29 C.F.R. § 1980.104(b)(1) (outlining the burden of proof under Sarbanes-Oxley) (emphasis added).

21. *Allen v. Admin. Review Board*, 514 F.3d 468, 477 (5th Cir. 2008).

22. www.michaelmoore.com/words/message/index.php?messageDate=2009-02-11 (“Will You Help Me With My Next Film? . . . a request from Michael Moore” posted February 11, 2009, last visited June 2, 2009).

23. Gerard Sinzdek, *An Analysis of Current Whistleblower Laws: Defending a More Flexible Approach to Reporting Requirements*, 96 CAL. L. REV. 1633, 1661 (2008).

24. 558 F.3d 722 (7th Cir. 2009).

25. Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse* (available at www.acfe.com/documents/2008-rttn.pdf).