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Sharkey Case: New Protection for Whistleblowing Once Removed

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Under the Sarbanes-Oxley Act of 2002, publicly traded companies are prohibited from retaliating or discriminating against employees who report or assist in the investigation of conduct which violates specified federal laws or Securities and Exchange Commission (SEC) regulations. There have been a number of court decisions interpreting the whistleblower provision that provides this protection, but until now, none has dealt with the situation where an employee reports allegedly illegal conduct of a company other than his or her employer. Judge Robert W. Sweet of the Southern District of New York just broke the silence in this regard by broadly construing the whistleblower provision of Sarbanes-Oxley to cover such conduct.

Decided on January 14, *Sharkey v. J.P. Morgan Chase & Co.*[1] concerned a suit brought by a terminated employee under the whistleblower provision of Sarbanes-Oxley alleging that the plaintiff's superiors at J.P. Morgan had retaliated against her for reporting allegedly illegal activities of a long-time client responsible for $600,000 in annual revenue to the firm. The client at issue was an Israeli company that the plaintiff alleged was violating U.S. federal securities laws and U.S. laws against mail fraud, bank fraud, and money laundering. The suit was dismissed with leave to replead because the plaintiff had failed to plead the specific conduct of the client that she believed to have been illegal. Significantly, however, Judge Sweet read the whistleblower provision expansively, applying it for the first time to the reporting of conduct on the part of a company other than the purported whistleblower's own employer.

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Key Whistleblower Provisions of Sarbanes-Oxley

The Sarbanes-Oxley whistleblower provision[2] protects employees of companies whose securities are registered or that file reports under the Securities Act of 1934, who provide to their supervisors information or assistance in an investigation regarding conduct that the employee reasonably believes constitutes one of the following illegal activities:

- Mail Fraud
- Wire Fraud
- Bank Fraud
- Securities Fraud
- Violation of SEC Rules or Regulations
- Fraud Against Shareholders

The Sarbanes-Oxley provision protects such employees from:

- Discharge
- Demotion
- Suspension
- Threats
- Harassment
- Any Other Discrimination

To state a claim under the provision, an employee plaintiff must establish that: (1) the plaintiff engaged in protected activity; (2) the defendant knew or suspected that the plaintiff engaged in the protected activity; (3) the plaintiff suffered an unfavorable employment action; and (4) the circumstances are sufficient to raise an inference that the protected activity contributed to the unfavorable employment action.[3] To qualify as protected activity, "the complaining employee's belief that his employer's conduct violated one of the enumerated categories must be both objectively and subjectively reasonable."[4] But "an employee's reasonable but mistaken belief that an employer engaged in conduct that constitutes a violation of one of the six enumerated categories is protected."[5]

A person alleging discrimination under the whistleblower provision may file a complaint with the Department of Labor or, if six months pass without a final decision, bring an action in U.S. federal district court.[6]

Expansion and Modification of the Whistleblower Provision by Dodd-Frank

Enacted on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act greatly expanded the scope of whistleblower protection in many respects[7] and put into place a significant incentive structure that seems likely to substantially increase the volume of reporting to the SEC, if not internally within companies.

Perhaps one of the most widely discussed provisions of Dodd-Frank is its establishment of monetary incentives for employee "whistleblowers," defined by the statute as one or more individuals providing information relating to a violation of the securities laws to the SEC, which promises to those providing original information leading to a successful enforcement action, resulting in monetary sanctions exceeding $1 million, a payment of between 10% and 30% of the resulting sanctions.[8]

Dodd-Frank also enacted its own new whistleblower protection provision that expands upon the protections of the Sarbanes-Oxley whistleblower provision in a number of ways, for example by (1) arguably protecting whistleblowers who provide information to the SEC without requiring a reasonable belief in illegality of the actions reported,[9] and (2) allowing individuals alleging retaliation to bring an action directly in U.S. federal district court.[10]

Dodd-Frank amended the Sarbanes-Oxley whistleblower provision to:

- Protect employees of major credit rating agencies;[11]
- Extend the statute of limitations;
- Entitle individuals alleging discrimination to a trial by jury;

- Render unenforceable predispute arbitration provisions that mandate arbitration;[12] and
- Cover subsidiaries of publicly traded companies.[13]

Judge Sweet's Broad Reading of the Whistleblower Provision

In evaluating Sharkey's contention that the Sarbanes-Oxley whistleblower provision protects employees who report violations of the law by nonemployer parties, Judge Sweet first noted that the parties before him both agreed that no decisions had yet been reported with respect to this issue.[14] Judge Sweet then quoted the legislative history of Sarbanes-Oxley and stated that the purpose of the whistleblower provision is to "promote corporate ethics by protecting whistleblowers from retaliation," for which reason "it should not be read narrowly."[15] He further located in the legislative history Congress' intent that the whistleblower provision should counteract a "corporate code of silence" that discourages employees from reporting fraud both externally, to government authorities, and internally within a company.[16] Finally, noting that none of the cases cited by the defendants stood for the proposition that the whistleblower provision protects only employees who report illegal conduct *by their employers*, Judge Sweet concluded that, under the language of the whistleblower provision and its legislative history, Sharkey's reporting of allegedly illegal activity by her employer's client constituted protected activity under Sarbanes-Oxley.

The Implications of *Sharkey* for Companies

Judge Sweet's decision in *Sharkey* places companies covered by Sarbanes-Oxley and their compliance departments on notice that a wider array of "whistleblower" activity may be protected by the Act than they probably believed. Individuals operating in a supervisory capacity should be aware that any reports that they receive from subordinate personnel regarding alleged illegal activity by a client or customer falling under the six categories enumerated in the statute, or any participation by subordinate personnel in an investigation of such illegal activity conducted by that supervisor, is potentially protected by the whistleblower provision of Sarbanes-Oxley. Individuals responsible for regulatory compliance at the company, and not otherwise conflicted, should be made aware whenever such information is provided by an employee to a supervisor. The company will be responsible to ensure that no actions are taken with regard to that employee that constitute an unfavorable employment action motivated by knowledge of the employee's provision of that information.

A company's responsibility for not ignoring its clients' lack of compliance with the law becomes all the more important in the context of an expansive whistleblower provision. Action challenged as retaliatory under Sarbanes-Oxley might appear to have taken place because the reporting employee's supervisor(s) had reached different conclusions about the legality of the client's conduct; if the conduct was, in fact, unlawful, then the entire episode might be viewed as revealing weakness in the employer's compliance procedures.[17] Adherence to strict client due diligence procedures at all times can help avoid such a pitfall.

The *Sharkey* decision is of particular moment for large financial services companies that service clients heavily engaged in activities regulated under the statutes enforced by the SEC. Financial firms must take reports of illegal activity by clients seriously for independent regulatory reasons; in light of *Sharkey*, they must also ensure that supervisory personnel not take retaliatory action against the employees doing the reporting. *Sharkey*, where the whistleblower alleged that a foreign client violated multiple U.S. laws, highlights the difficulty faced by large firms operating throughout the world. Companies need to subject the activities of their clients to an appropriate level of scrutiny regardless of geographical location.

In light of Dodd-Frank's (1) recent establishment of significant financial incentives for reporting; (2) creation of new and broad whistleblower protections; and (3) expansive amendment of the Sarbanes-Oxley whistleblower provisions—the implications and effects of all of which have yet

to be fully felt or predicted—*Sharkey* compounds the difficulty of complying with the presently uncertain body of whistleblower regulations.

Following *Sharkey*, corporate compliance personnel should be made aware of their responsibilities under the Sarbanes-Oxley whistleblower provision and the potential expansion of those responsibilities under Dodd-Frank should Judge Sweet's view come to be widely adopted.

NOTES

1. *Sharkey v. J.P. Morgan Chase & Co.*, 2011 WL 135026 (S.D. N.Y. 2011).
2. *See* Sarbanes-Oxley Act of 2002, 18 U.S.C.A. § 1514A(a).
3. 29 C.F.R. § 1980.104(b)(1)(i)-(iv); *Fraser v. Fiduciary Trust Co. Intern.*, 417 F. Supp. 2d 310, 322, 37 Employee Benefits Cas. (BNA) 1195, 24 I.E.R. Cas. (BNA) 246, 87 Empl. Prac. Dec. (CCH) P 42268, Fed. Sec. L. Rep. (CCH) P 93708 (S.D. N.Y. 2006).
4. *Fraser v. Fiduciary Trust Co. Intern.*, 48 Employee Benefits Cas. (BNA) 1500, 29 I.E.R. Cas. (BNA) 1069, 92 Empl. Prac. Dec. (CCH) P 43661, 2009 WL 2601389, at *5 (S.D. N.Y. 2009), aff'd, 31 I.E.R. Cas. (BNA) 491, 2010 WL 4009134 (2d Cir. 2010).
5. *Allen v. Administrative Review Bd.*, 514 F.3d 468, 477, 27 I.E.R. Cas. (BNA) 140, 90 Empl. Prac. Dec. (CCH) P 43081, 2008 O.S.H. Dec. (CCH) P 32935 (5th Cir. 2008).
6. Sarbanes-Oxley, 18 U.S.C.A. § 1514A(b).
7. *See* Alan D. Berkowitz, Claude M. Tusk, J. Ian Downes, & David S. Caroline, "Whistleblowing," 36 Emp. Rel. L.J. 4, 18-22 (forthcoming Spring 2011); Kathleen N. Massey & Jason O. Billy, "The New Dodd-Frank Whistleblower Program Takes Shape as the Securities and Exchange Commission Releases Proposed Rules," *DechertOnPoint*, Special Alert (November 2010), http://www.dechert.com/library/White_Collar_SA_11-10_New_Dodd-Frank_Whistleblower_Program.pdf.
8. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), 15 U.S.C.A. § 78u-6.
9. *See* Dodd-Frank § 78u-6(h)(1)(A). The manner in which a whistleblower must report, however, will be determined by the SEC rule-making process now underway. Dodd-Frank § 78u-6(a)(6). Under the proposed rules for implementing the Dodd-Frank whistleblower provision, a whistleblower seeking to receive a monetary award for information provided to the SEC would need to certify that the all of the information in his submission "is true, correct and complete to the best of the whistleblower's knowledge, information and belief." Proposed Rules for Implementing the Whistleblower Provisions of § 21F of the Securities Exchange Act of 1934, Exchange Act Release No. 34-63237, 75 Fed. Reg. 70,488, 70,503, 70,506, 70,512 (proposed Nov. 3, 2010) (to be codified at 17 C.F.R. pts. 240 and 249). The whistleblower must acknowledge his understanding that he may be subject to prosecution and ineligible for an award if he has knowingly and willfully submitted any false information or made false statements. Fed. Reg. at 70,503, 70,506.
10. *See* Dodd-Frank § 78u-6(h)(1)(B)(i).
11. Dodd-Frank § 922(b).
12. Dodd-Frank § 922(c).
13. Dodd-Frank § 929A. Previously, many courts had held that employees of nonpublicly traded subsidiaries were not protected. *See, e.g.*, *Malin v. Siemens Medical Solutions Health Services*, 638 F. Supp. 2d 492, 499-501 (D. Md. 2008), subsequent determination, 29 I.E.R. Cas. (BNA) 1078, 2009 WL 2500289 (D. Md. 2009); *Rao v. Daimler Chrysler Corp.*, 89 Empl. Prac. Dec. (CCH) P 42814, 2005 O.S.H. Dec. (CCH) P 32891, 2007 WL 1424220, at *4-*5 (E.D. Mich. 2007).
14. *Sharkey*, 2011 WL 135026, at *5.
15. *Sharkey* (citing *Mahony v. KeySpan Corp.*, 89 Empl. Prac. Dec. (CCH) P 42879, 2007 WL 805813, at * 5 (E.D. N.Y. 2007).
16. *Sharkey* (citing S. Rep. No. 107-146, as reprinted in 2002 WL 863249, at *5).
17. *See Sharkey*, 2011 WL 135026, at *1.