

SOX AND WHISTLEBLOWING

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The language of the Sarbanes-Oxley Act (“SOX”) leaves no doubt that Congress intended whistleblowing to be an integral part of its enforcement mechanisms. The Act attempts to encourage and protect whistleblowers in a variety of ways, including providing for anonymous whistleblowing, establishing criminal penalties for retaliation against whistleblowers, and clearly defining whistleblowing channels. Unfortunately, these provisions give the illusion of protection for whistleblowers without effectively providing it. There is increasing evidence that virtually no whistleblower who has suffered retaliation and pursued remedies under SOX has been successful. Additionally, social science research and studies of whistleblowing laws indicate that SOX is unlikely to increase reports.

This Article compares the SOX whistleblowing provisions with other state and federal whistleblowing statutes, discusses the shortcomings of the SOX provisions, and explains why SOX needs to be revised in order to help ensure the integrity of the markets. Recommended revisions include significantly rewarding whistleblowers that come forward with novel and relevant information. Experience with the False Claims Act and equivalent state statutes show such incentive legislation to be the only truly effective legislative model. The Article goes on to discuss various ways to create an incentive reward fund. While some of the current law as well as some of the suggested revisions potentially put SOX in conflict with privacy and whistleblowing laws of European countries, the conflicts can be eliminated through judicious use of exemptions and/or through judicial interpretation.

TABLE OF CONTENTS

INTRODUCTION	1758
I. WHISTLEBLOWING UNDER SOX	1759
A. Comparative Coverage.....	1759
B. Retaliation	1761
II. THE INADEQUACIES OF SOX WHISTLEBLOWING.....	1764
A. Inadequate Protection for Whistleblowers	1764
B. Failure in Spurring Whistleblowing	1768
1. Protective Whistleblower Legislative Model.....	1768
2. Incentive Legislation.....	1769
III. EFFECTIVE SOX WHISTLEBLOWING	1773
A. The Foreign Reach of Sarbanes Oxley.....	1774
B. Exemptions	1777
CONCLUSION	1779

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INTRODUCTION

The Sarbanes-Oxley Act of 2002 (“SOX”)¹ represents a reification by the United States Congress of the importance of whistleblowing in the control, detection, and deterrence of wrongdoing. It followed the dramatic growth of whistleblowing laws in the 1980s and 1990s,² along with a growing hostility and distrust of big business and government. However, it was the wrongdoing, scandals, and resultant publicity, and the anger brought on by the leaders of failed corporations such as Enron and WorldCom that were the particular impetus for the law.³ Whistleblowers were important in bringing the wrongdoing to light⁴ and in testifying before Congress in hearings about the law.⁵ Today they play a crucial role in SOX enforcement.

SOX has been controversial since its enactment⁶ and has been challenged on a variety of grounds including charges that it is unconstitutional⁷ and too costly, especially for small business⁸ and foreign companies.⁹ It has also been blamed in part for reduced foreign listings on the New York Stock

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C).

2. See Elletta Sangrey Callahan & Terry Morehead Dworkin, *The State of State Whistleblower Protection*, 38 AM. BUS. L.J. 99, 99–115 (2000) [hereinafter Callahan & Dworkin, *State Whistleblower Protection*].

3. See, e.g., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (2002), available at <http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf>; Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 924–25 (2003). Other companies that collapsed relatively soon thereafter as a result of corporate wrongdoing include Global Crossing, Tyco, and Adelphia. *Id.*

4. Michael Orey, *WorldCom-Inspired ‘Whistleblower’ Law Has Weaknesses*, WALL ST. J., Oct. 1, 2002, at B1. Indeed, of the three female whistleblowers named “People of the Year” by *Time Magazine* in 2002, two, Sherron Watkins and Cynthia Cooper, blew the whistle on Enron and WorldCom, respectively. Richard Lacayo & Amanda Ripley, *Persons of the Year*, TIME, Dec. 30, 2002, at 30.

5. See S. REP. NO. 107-146, at 5 (2002). See also JOHN T. BOSTELMAN, 1 THE SARBANES-OXLEY DESKBOOK 2–30 (Rel. 8 2005).

6. SOX has been described as having “garbage provisions” that are like “military strategist[s] fighting the last war rather than planning for the next.” Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers* 3–4, n.21 (2006) (quoting See Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and it just might work)*, 35 CONN. L. REV. 915, 918–19 (2003)) (article on file with author).

7. *Lawsuit Challenges Enactment of SOXA, Creation of PCAOB as Unconstitutional*, 74 U.S. L. WK. (BNA) 2487 (Feb. 21, 2006).

8. See, e.g., Heather Brewer, *Snap Judgments*, BUS. L. TODAY, May-June, 2006, at 6, 7; *Support Mounts For ‘Rolling Back’ Sarbanes-Oxley 404 For Smallest Public Companies, As Nasdaq CEO Adds Public Support*, FINANCIALWIRE, Mar. 7, 2006, available at 2006 WLNR 3787209.

9. E.g., Alan Murray, *Panel’s Mission: Easing Capital-Market Rules*, WALL ST. J., Sept. 12, 2006, at A2. The article points out that nine of the ten biggest initial public offerings in 2006 were done overseas. Many experts, it states, believe this reflects the legislative, legal, and regulatory burdens that public companies do not face when selling stock overseas. “European companies are . . . likely to cite the burdens of [regulations which] require[] them to spend millions of dollars on a detailed internal-control report.” *Id.*

Exchange.¹⁰ In response to these and other complaints, many commentators and legislators have proposed amendments to SOX.¹¹ In addition, because SOX is relatively new and litigation is evolving, there are still many unanswered questions about its effectiveness, scope, and application that create something of a moving target for reformers.¹² One important question is whether SOX will be effective in getting observers of wrongdoing to report it. Another is whether the whistleblower enforcement mechanisms will run afoul of laws in other countries.

The first Part of this Article contains a comparative discussion of whistleblowing under the provisions of SOX. The following Part discusses why, from a social science research and practical perspective SOX is not proving effective in protecting whistleblowers. The third Part analyzes the likely ineffectiveness of SOX to spur whistleblowing and the incentive legislation that would better achieve this. The fourth Part discusses the extraterritorial reach of the whistleblowing sections of SOX and proposals for exemptions. The final Part proposes reforms of the whistleblowing sections to better achieve the intended goals of SOX.

I. WHISTLEBLOWING UNDER SOX

A. Comparative Coverage

There are three whistleblower sections to SOX. The most important, Section 806, states that a covered company cannot “discharge, demote, suspend, threaten, harass, or in any other manner discriminate” against a whistleblower who reports covered information to someone within the organization who “has the authority to investigate, discover, or terminate

10. Harvey Pitt, *Sarbanes-Oxley is an unhealthy export*, FIN. TIMES (London), June 21, 2006, available at <http://www.ft.com/cms/s/232bdc7a-00c3-11db-8078-0000779e2340.html> (last visited Jan. 31, 2007) (“Congress’s exportation of Sox’s standards has created huge difficulties for multinational companies and produced scorn for US standards. This embodiment of American geocentrism has resulted in a loss of foreign listings on US exchanges and diversion of initial public offerings to non-US locales.”); Alistair Osborne, *The post-Enron protection risks penalising everybody*, THE DAILY TEL. (LONDON), May 26, 2006, at City 2 (“[SOX] rules have raised the cost of doing business in New York so much, it is in danger of losing its status as the world’s foremost financial market. Money is fleeing to Europe and London in particular . . .”).

In an international survey of members of boards of directors, a majority felt that SOX rendered boards of directors overly cautious and made it more difficult to get people to serve as directors. The survey, conducted by Korn/Ferry, included responses of nearly 1200 board members from fifteen nations. PRNewswire.com, *Majority of Board Directors Feel Sarbanes-Oxley Regulations Should be Repealed or Overhauled*, <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=109&STORY=/www/story/02-23-2006/0004287861&EDATE=> (last visited Jan. 25, 2007).

11. Murray, *supra* note 9 (discussing how the newly-formed Committee on Capital Markets Regulation, in coordination with Treasury Secretary Henry Paulson, is attempting to provide political cover for “difficult legislative and regulatory changes”). The Commission includes the CEOs of PricewaterhouseCoopers, Deloitte, Office Depot, and DuPont, among others.

12. Another factor in the move to reform SOX was the anticipated retirement of Sarbanes and Oxley, who were anticipated to retire in 2007, and the resultant change in the leadership of committees that regulate Wall Street, banks and finance. Brody Mullins, *Capitol’s New Bank Examiners*, WALL ST. J., Sept. 12, 2006, at A4.

misconduct.”¹³ In specifying to whom the whistleblowing report should be made, SOX is like most of the U.S. state and federal whistleblowing statutes.¹⁴ It also comports with the commonly understood definition of whistleblowing as “the disclosure by organization members (former or current) of illegal, immoral, or illegitimate practices under the control of their employers to persons or organizations that may be able to effect action.”¹⁵ Additionally, like virtually every whistleblower statute, domestic or foreign, whistleblowers are not required to be correct in order to be protected.¹⁶ They must merely reasonably believe that the information concerns a covered violation.¹⁷

Section 806 is unusual in specifying internal whistleblowing as an appropriate channel. Most state and federal statutes designate only an external recipient.¹⁸ In this regard, SOX follows common whistleblower practice since internal reporting is the most common type of initial whistleblowing.¹⁹ Benefits of internal whistleblowing include facilitating the prompt investigation and correction of wrongful conduct and minimizing the organizational costs of whistleblowing by permitting employers to rectify misconduct confidentially, with little disruption to the employer-employee relationship. Internal whistleblowing also enables the correction of misunderstanding, which reduces the likelihood that the organization and its employees will unfairly suffer harm. However, it may also allow for cover-ups, as happened in some of the recent scandals.

Another distinctive section of SOX is the requirement of a channel for anonymous whistleblowing. This provision is unique among whistleblower statutes.²⁰ Section 301 of SOX requires audit committees of covered companies to establish whistleblowing procedures whereby employees can

13. Sarbanes-Oxley Act of 2002 § 806(a), 18 U.S.C. § 1514A (Supp. II 2002). In addition, the section specifically protects those who cooperate in a legal investigation or a Congressional investigation. *Id.*

14. See Elletta Sangrey Callahan & Terry Morehead Dworkin, *Who Blows the Whistle to the Media and Why: Organizational Characteristics of Media Whistleblowers*, 32 AM. BUS. L.J. 151, 153–58 (1994) [hereinafter Callahan & Dworkin, *Media Whistleblowers*].

15. MARCIA P. MICELI & JANET P. NEAR, *BLOWING THE WHISTLE* 15 (1992). This definition is broader than the definition of protected disclosure in most laws because they generally don't encompass ethics or “immoral” violations. The most common definition is a violation of a law, rule, or regulation. See *id.* at 260–273 tbl.6-2.

16. See Elletta Sangrey Callahan et al., *Whistleblowing: Australian, U.K., and U.S. Approaches to Disclosure in the Public Interest*, 44 VA. J. INT'L L. 879, 898–99 (2004).

17. Sarbanes-Oxley Act of 2002 § 806(a), 18 U.S.C. § 1514A(1) (Supp. II 2002). If the complaint is deemed frivolous, the judge can order up to \$1,000 in reasonable attorneys' fees. Procedures, 29 C.F.R. § 1980.109(b)(2004).

18. Terry Morehead Dworkin & Elletta Sangrey Callahan, *Internal Whistleblowing: Protecting the Interests of the Employee, the Organization, and Society*, 29 AM. BUS. L.J. 267, 276–79 (1991).

19. *Id.* at 301; Marcia Parmerlee Miceli & Janet P. Near, *The Relationships Among Beliefs, Organizational Position, and Whistle-Blowing Status: A Discriminant Analysis*, 27 ACAD. OF MGMT. J. 687, 701 (1984) [hereinafter Miceli & Near, *A Discriminant Analysis*].

20. Media whistleblowing is the usual anonymous route. However, no statute authorizes this practice. See Callahan & Dworkin, *Media Whistleblowers*, *supra* note 14, at 157.

anonymously submit issues of concern regarding questionable accounting or auditing matters.²¹ Further, it requires the committees to have procedures for retaining and treating the reports. Most commonly, the organizational response to this requirement has been to contract with an independent hotline company to receive the reports.²²

A person who reports the suspected fraud externally must give the information to a federal regulatory or law enforcement agency, or to any member or committee of Congress in order to be protected. As in virtually all whistleblowing statutes,²³ SOX does not protect whistleblowers who go to the media.²⁴ While studies of media whistleblowers indicate that these whistleblowers are as responsible as other whistleblowers and have good reasons to resort to the media, domestic and foreign legislators seem not to trust them or to encourage this kind of reporting.²⁵

B. Retaliation

If the whistleblower suffers retaliation for reporting, § 806(a) gives the employee the right to bring a civil suit. Before that can happen, the employee must first file a complaint with the Secretary of Labor, who then refers it to the Occupational Safety and Health Administration for investigation. An administrative law judge of the Department of Labor hears the evidence resulting from the investigation and renders a decision.²⁶ The case will not go forward if the employer can show by clear and convincing evidence that it would have taken the action in the absence of the whistleblowing.²⁷ Congress established a time limit of 180 days within which the Secretary of Labor should render a decision based on this process.²⁸

21. 15 U.S.C. § 78j-1(m)(4) (Supp. II 2002). According to the Association of Certified Fraud Examiners, employee tips “are the single most effective means of detecting fraud.” Archie B. Carroll, *Carroll: Fighting workplace fraud is huge daily problem*, OnlineAthens.com, (June 21, 2003), http://www.onlineathens.com/stories/062203/bus_20030622014.shtml (last visited Jan. 29, 2007).

22. Jennifer Bjorhus, *Hot Lines Hot: Watchdog law has companies scrambling to line up off-site services to record anonymous employee comments*, ST. PAUL PIONEER PRESS, Oct. 12, 2004, at D1. Hotlines are discussed in further detail below. One example of a hotline company is Management Communication Systems. It reports it runs the “In Touch” hotline system for about 150 companies worldwide. Other major firms are The Network Inc., EthicsPoint Inc., and National Hotline Services Inc. Since these companies are private, it is difficult to get an estimate of their sales numbers. *Id.*

23. Callahan & Dworkin, *Media Whistleblowers*, *supra* note 14, at 157.

24. See 18 U.S.C. § 1514A (Supp. II 2002).

25. Callahan et al., *supra* note 16, at 893–95.

26. The decision can be appealed to the Administrative Review Board of the Department of Labor.

27. Sarbanes-Oxley § 806, 18 U.S.C. § 1514A; 49 U.S.C. § 42121(b)(2)(B)(ii)(2000). The plaintiff must show that his or her whistleblowing actions were a contributing factor in the unfavorable personnel decision. See, for example, *Collins v. Beazer Homes USA, Inc.*, 334 F. Supp. 2d 1365, 1378–79 (N.D. Ga. 2004) and *Murray v. TXU Corp.*, 279 F. Supp. 2d 799 (N.D. Tex. 2003) for interpretations of this section.

28. Sarbanes-Oxley § 806, 18 U.S.C. § 1514A.

If there is no decision in 180 days, then the employee may bring a civil suit for de novo review in the district court.²⁹ This creates the potential for conflicting decisions and duplicative litigation because the whistleblower can file a lawsuit in the district court while the administrative proceeding is still pending.³⁰ At least one court distinguished between this theoretical concern and the case before it because under the circumstances of the current case it did not lead to “an absurd result.”³¹ This was particularly true because the district courts can conduct a de novo review.³²

SOX, in defining retaliation as encompassing discharging, demoting, suspending, threatening, harassing, “or in any other manner discriminat[ing]” against the whistleblower, statutorily encompasses a broader definition of prohibited retaliation than most state whistleblower laws.³³

The definition of covered employees is similarly broad. It includes current and former employees and applicants.³⁴ Most whistleblower statutes do not cover applicants.³⁵ The coverage applies not only to publicly traded companies³⁶ but also to contractors, subcontractors and agents of those com-

29. 18 U.S.C. § 1514A(b)(1)(B).

30. DOL regulations recognized this conflict and further stated:

The Act might even be interpreted to allow a complainant to bring an action in Federal court after receiving a final decision from the Board The Secretary believes that it would be a waste of the resources of the parties, the Department, and the courts for complainants to pursue duplicative litigation.

68 Fed. Reg. § 31860, 31863 (May 28, 2003).

31. *Hanna v. WCI Communities, Inc.*, 348 F. Supp. 2d 1322, 1329 (S.D. Fla. 2004). The court examined whether it could ignore the plain meaning of the statutory language and stated this should be done only if the language is ambiguous, there is clear evidence of contrary legislative intent, or it would lead to an absurd result. The first two did not apply and it used the absurd result standard. The court presumed that Congress passed the statute as a spur to the DOL to give timely relief to SOX plaintiffs. It found no reason to penalize the plaintiff for what may be an unrealistic timetable imposed by Congress. The resolution lies with Congress. *Id.* In addition to his SOX claims, plaintiff also filed suit under Florida’s whistleblower statute.

32. *Id.* The court went on to reject the argument that plaintiff had to exhaust his administrative remedies before he could file suit in district court and the argument of collateral estoppel. *Id.* at 1330–31. In *Bechtel v. Competitive Technologies, Inc.*, 448 F.3d 469, 474 (2nd Cir. 2006), the court noted:

Given these successive levels of review, the absence of federal judicial power to enforce preliminary orders reasonably could serve to ensure that appeals work their way through the administrative system before the federal courts become involved. Moreover, if the result changes from one level of review to the next, immediate enforcement at each level could cause a rapid sequence of reinstatement and discharge and a generally ridiculous state of affairs.

33. See MICELI & NEAR, *supra* note 15, at 243–50; see also Section 806, titled “Protection for Employees of Publicly traded Companies Who Provide Evidence of Fraud,” codified at 18 U.S.C. § 1514(a) and *Willis v. Vie Financial Group, Inc.*, No Civ. A. 04-435, 2004 WL 1774575 (E.D. Pa. Aug. 6, 2004) (significant changes in job responsibilities are covered retaliation).

34. This includes someone applying to the company or company representative. Company representative includes any officer, employee, contractor or subcontractor, or agent of a company. 29 C.F.R. § 1980.101 (2004).

35. See MICELI & NEAR, *supra* note 15, at tbls.6-1 & 6-2.

36. The statute states that this includes any company that registers its securities or must file reports under the Securities Exchange Act. See 29 C.F.R. § 1980.101.

panies.³⁷ This means, for example, that if an accountant for Arthur Anderson suffered retaliation for reporting fraud at Enron (as was alleged), the accountant could file a SOX complaint. The law is sufficiently vague that it may also cover U.S. citizens working for a foreign-listed publicly traded company overseas or for a private foreign subsidiary of a covered U.S. company, or a foreign employee working for a foreign subsidiary.³⁸ If this is the case, SOX may run afoul of European privacy law and the whistleblowing statutes of other countries.

The effectiveness of the protection offered by Section 806 is tempered by the very short statute of limitations of ninety days after a retaliatory action occurs.³⁹ Most potential claimants don't realize what their rights are and how to pursue them in such a short period.⁴⁰ Additionally, the remedies provided are more limited than may at first appear.

The statutory language says that a successful claimant "shall be entitled to all relief necessary to make the employee whole."⁴¹ But it then goes on to limit recovery to equitable compensatory damages.⁴² Earlier studies of whistleblower statutes show that if an employee could not recover punitive and emotional injury damages, the statutes did not spur whistleblowing nor did they adequately compensate the employee for the risks taken in reporting suspected wrongdoing.⁴³

The provision for criminal penalties for knowing and intentional retaliation that was implemented in SOX is a significant departure from most whistleblowing laws. Section 1107 imposes penalties on companies

37. *Id.*

38. In *Camero v. Boston Scientific Corp.*, No. 04-10031-RWZ, 2004 U.S. Dist. LEXIS 17205 (D. Mass. Aug. 27, 2004), *aff'd*, 433 F.3d 1 (1st Cir. 2006), the court held that SOX did not cover an Argentinean citizen working for a foreign subsidiary of a U.S. parent corporation. A few administrative law judges have followed this precedent.

39. Sarbanes-Oxley § 806, 18 U.S.C. § 1514A. The original bill had a 180-day limitation period, but it was changed to ninety days through an amendment from Senators Grassley and Leahy. See Beverly Earle & Gerald A. Madek, *The Mirage of Whistleblower Protection under Sarbanes Oxley: A Proposal for Change 6* (2006) (on file with author).

40. See 18 U.S.C. § 1514A(b)(1)(B) (2002). See also *Hanna v. WCI Communities, Inc.*, 348 F. Supp. 2d 1322, 1329 (S.D. Fla. 2004); Willis, 2004 WL 1774575 (plaintiff failed to file his complaint regarding a threatened termination within the ninety-day period and failed to amend his complaint to include his later firing, and therefore could not seek a remedy).

41. 18 U.S.C. § 1514A(c)(1).

42. Listed damages include reinstatement with the same seniority, back pay with interest, and compensation for any special damages resulting from the discrimination including litigation costs, expert witness fees and reasonable attorney fees. *Id.* § 1514A(c)(2).

43. EARLE & MADEK, *supra* note 39, at 13 (arguing that reporting may be harmful to an employee's future and that the area covered by SOX is difficult for employees to understand compared to sexual harassment or labor issues); Terry Morehead Dworkin & Janet P. Near, *Whistleblower Statutes and Reality: Is There a Need for Realignment?* (1990) (on file with author) [hereinafter Dworkin & Near, *Whistleblower Statutes and Reality*]; see also James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OR. L. REV. 435, 440 (2004) ("The whistleblowers, who have the company's interests most at heart, are rarely forgiven . . . and they spend their lives in misery, shunned by employers. For example, Watkins's revelation of fraud in Enron led the company initially to consider, with advice of outside counsel . . . whether and how to fire her:").

or individuals that knowingly and intentionally retaliate against a whistleblower who gives truthful information about any federal offense to a law enforcement officer.⁴⁴ While criminal penalties are not unprecedented—a few U.S.⁴⁵ and Australian states,⁴⁶ for example, impose criminal penalties for retaliation against whistleblowers—SOX's criminal penalties are unique in federal whistleblower legislation. If convicted, the intentional retaliator is subject to a fine and/or imprisonment for up to ten years. Congress, however, set a high bar for imposing these penalties: the whistleblower must be correct and there must be a showing of intent.

Section 1107 is also broadly written. It covers retaliation against whistleblowers that provide information to a law enforcement officer about *any* federal offense. There is great potential for a broad application to whistleblowing about non-securities issues. Also, this section applies to any company, including nonprofits, and individuals within an organization. It could also apply to non-organization members.⁴⁷ Finally, Section 1107 defines retaliation as taking “any action harmful to any person, including interference with the lawful employment or livelihood of any person”⁴⁸ In terms of whistleblowing, this section has the potential to become the most important of all the SOX provisions because it could develop into a general whistleblower protection statute.⁴⁹

II. THE INADEQUACIES OF SOX WHISTLEBLOWING

A. *Inadequate Protection for Whistleblowers*

Despite the intended promotion and use of whistleblowing to help enforce Sarbanes-Oxley and deter wrongdoing in the securities market,⁵⁰ the statutory scheme gives the illusion of protection without truly meaningful opportunities or remedies for achieving it.⁵¹

This ineffectiveness is borne out by statistics regarding cases brought so far. In a study conducted by Professors Earle and Madek, they report that through May 2006, of the 677 completed Sarbanes-Oxley complaints, 499

44. The statutory language is: “knowingly, with intent to retaliate, takes any action harmful to any person” 18 U.S.C. § 1513(e) (2002).

45. See MICELI & NEAR, *supra* note 15, at 260–73.

46. See, e.g., Whistleblower Protection Act 2001, Act No. 36/2001, 2 Vict. Acts 36, § 18; Protected Disclosures Act 1994, No. 92, § 20(1)-(1A) (N.S.W. CONSOL. ACTS), available at http://www.austlii.edu.au/au/legis/nsw/consol_act/pda1994251/s20.html; Public Interest Disclosure Act 1994, No. 108, § 25 (AUSTL. CAP. TERR. LAWS).

47. The language states retaliation against “any person.” See *supra* note 44.

48. *Id.*

49. Cf. *In re JDS Uniphase Corp. Sec. Litig.*, 238 F. Supp. 2d 1127 (N.D. Cal. 2002) (holding that based on the public policy behind SOX, employee silence agreements required by the employer could not be used to prevent employees from voluntarily reporting or discussing wrongdoing).

50. See, e.g., *Murray v. TXU Corp.*, 279 F. Supp. 2d 799 (N.D. Tex. 2003).

51. See EARLE & MADEK, *supra* note 39, at 20–38, for a discussion of illustrative cases.

were dismissed and 95 were withdrawn. This demonstrates that, at the least, success at this level is an uphill battle.⁵² Of the cases that went to an administrative law judge (“ALJ”), only 6 (two percent) of the 286 resulted in a decision for the employee.⁵³ Some of the reasons for this lack of success have already been mentioned: the procedural complexity in bringing a claim, the very short statute of limitations, and the inadequacy of remedies, considering the risk and time it takes to negotiate a claim to conclusion.

An example of these problems is shown by the well-publicized case of *Welch v. Cardinal Bankshares Corp.*⁵⁴ Welch, the chief financial officer of Cardinal Bankshares, refused to certify the organization’s financial statements because of company auditing practices and possible insider trading. He notified the CEO and the auditor about his concerns. He was fired in October 2002. Welch filed a claim with the Occupational Safety and Health Administration (“OSHA”); the hearing officer found that the company had cause to fire him. Welch appealed that decision to the ALJ, who held in January 2004 that Welch had shown that he was fired because he had complied with his duty to disclose information, and he ordered Welch reinstated.⁵⁵

The ALJ decision regarding Welch was appealed to the Administrative Review Board (“ARB”), which dismissed it. In February 2005, the OSHA ALJ then issued a Supplemental Recommended Decision and Order. The company had argued that Welch would have been fired anyway because of the enmity and distrust between Welch and the other employees, and because he was unfit. Further, it argued the remedy was inappropriate because another employee would have to be fired to reemploy Welch.⁵⁶ These arguments were rejected and the judge ordered that Welch be made whole. Both the respondent and Welch appealed. Welch wanted reinstatement; the company objected to the make whole remedies. The ARB on March 31, 2006, decided that the reinstatement order of February 2005 was in effect. Cardinal was given leave to appeal to the ARB to stay the effect of the preliminary order. This is where the case stands.

Both Welch and his family have had to pay a high price for his whistleblowing and the subsequent claim. Welch had trouble finding a job after his firing and was unemployed until April 2003. His job was abolished in May 2004, and he has been unemployed since then.⁵⁷ While waiting for the last

52. *Id.* at 17–18; Deborah Solomon, *For Financial Whistle-Blowers, New Shield Is an Imperfect One*, WALL ST. J., Oct. 4, 2004, at A1.

53. EARLE & MADEK, *supra* note 39, at 19. There were thirty settlements.

54. 454 F. Supp. 2d 552 (W.D. Va. 2006). Welch’s situation was detailed in a front-page article in the *Wall Street Journal*. Solomon, *supra* note 52.

55. 2003 SOX 15 (DOL Aug. 1, 2003).

56. *Welch v. Cardinal Bankshares Corp.*, 454 F. Supp. 2d 552 (2006).

57. This is not surprising since companies are reluctant to hire whistleblowers and they are often pariahs in the industry. See Elletta Sangrey Callahan & Terry Morehead Dworkin, *Do Good and Get Rich: Financial Incentives For Whistleblowing and the False Claims Act*, 37 VILL. L. REV. 273, 324 (1992) [hereinafter Callahan & Dworkin, *Do Good and Get Rich*]; Terry Morehead

decision in his favor, he had to sell his farm and he and his family moved to a smaller house. He and his wife drained their retirement accounts. And the issue is not yet settled.⁵⁸ The limited SOX statutory remedies, as discussed above, cannot make him whole.

The limited success of whistleblowers who attempt to obtain remedies through the designated government complaint process was foreshadowed by the experiences of federal government employee whistleblowers. The Civil Service Reform Act (“CSRA”) was passed to give better protection to whistleblowers reporting government wrongdoing.⁵⁹ The CSRA designated the Office of Special Counsel (“OSC”) to handle whistleblower complaints and protect them from retaliation.⁶⁰ The OSC was supposed to act as an advocate that could pursue claims for employees who suffered retaliation. Instead, the OSC “lost sight of its mission”⁶¹ and failed to carry out its mandate. As a result, retaliation increased, up to ninety percent of employees lost their appeals, and whistleblowing declined.⁶² The CSRA was then amended in 1989 by the Whistleblower Protection Act to strengthen the OSC. The amended Act required that the head of the OSC be an attorney qualified to carry out the office’s function. Protection for whistleblowers was also increased in several ways, including easing the burden of proof and allowing employees to pursue their own claims if the OSC failed to take their claims to the Merit Systems Protection Board.⁶³ However, the amended Act did not allow for damages nor did it extend the limited statute of limitations. Again, its protection proved inadequate. Among other signs of failure, only one of the 120 appeals brought by whistleblowers to the Federal Circuit Court of Appeals—the designated recipient—has been successful since 1984.⁶⁴

Further amendments that attempt to make whistleblower protection more effective for government employees have been passed by the House⁶⁵

Dworkin & Janet P. Near, *Whistleblowing Statutes: Are They Working?*, 25 AM. BUS. L.J. 241, 262 n.102 (1987) [hereinafter Dworkin & Near, *Whistleblowing Statutes*].

58. Solomon, *supra* note 52.

59. See 5 U.S.C. § 2302 (2000).

60. 5 U.S.C. § 1206 (1988) (repealed 1989). The OSC is also charged with investigating and pursuing reports of wrongdoing, and remedying it. *Id.*

61. Rhonda McMillion, *Aiding Whistle-Blowers*, A.B.A. J., Mar. 1989, at 121, 121 (quoting Rep. Patricia Schroeder).

62. See Thomas M. Devine & Donald G. Aplin, *Abuse of Authority: The Office of the Special Counsel and Whistleblower Protection*, 4 ANTIOCH L.J. 5, 25–26 (1986).

63. 5 U.S.C. § 1221 (2000).

64. Press Release, Gov’t Accountability Project, Senate Approves Whistleblower Rights Breakthrough (June 23, 2006). The Government Accountability Project (“GAP”) stated that the court had effectively gutted protection for whistleblowers by refusing to protect them. See *id.*

65. Included in the House measure is broadening the definition of retaliation to prohibit punitive denial of security clearance, retaliatory investigations, and gag orders. It would also bar the President from ex post facto reclassifying an employee as an “intelligence employee” and thereby restricting their merit system protection rights after they have filed suit. It would restore the reasonable belief standard for protected reporting and extend coverage to national security employees and government contractors. Whistleblowers could disclose classified information to members of Congress on relevant oversight committees or to their staff. Federal Employee Protection of Disclosures

and Senate,⁶⁶ but as of this writing, they are not yet law.⁶⁷ Among the reforms is a measure that would give the Office of Special Counsel greater authority to seek disciplinary measures against managers who retaliate. If these reforms become law, government whistleblowers could have jury trials and jurisdiction would be restored to all circuit courts. Currently the Federal Circuit Court of Appeals has jurisdiction over appeals, and this court has found for the whistleblower only once in over 100 cases since 1999.⁶⁸

A different but potentially serious problem for employees seeking redress for retaliation is the use of arbitration agreements as a bar to suit. At least one court in a SOX case has so held. The court in *Boss v. Salomon Smith Barney, Inc.*⁶⁹ limited the plaintiff's rights by refusing to let him take his claim to the court because he had signed mandatory arbitration agreements when he was hired.⁷⁰ Since an increasing number of employers are requiring employees to sign such agreements, a significant number of employees could be denied meaningful SOX remedies.⁷¹

If over two decades of attempts to make protection effective for government employee whistleblowers have proven unsuccessful—especially given the existence of an official agency that is designed to act as advocate and protector for whistleblowers—it is highly unlikely that mere adjustments to the current SOX scheme, as proposed by some scholars, are likely to be successful. A more radical change is needed to create effective protection.

Act, H.R. 1317, 109th Cong. (2005); Executive Branch Reform Act of 2006, H.R. 5112, 109th Cong. (2006).

66. Senate bill 494 was passed as an amendment to the 2007 National Defense Authorization Act, 96-0 on June 22, 2006. The Senate bill was passed to overturn the Supreme Court decision of *Garcetti v. Ceballos*, 126 S. Ct. 1951 (2006). This decision narrowed the First Amendment speech protection for federal workers in whistleblowing cases, and reflects the appointment of a more conservative justice to the Court. The case was reargued before the Court after Justice O'Connor, who had written a prior decision protecting a government employee whistleblower, was replaced by Justice Alito. The *Garcetti* Court refused to protect the prosecutor who wrote a memo asking whether a sheriff's deputy had lied in an affidavit to get a search warrant, finding that when public employees make statements pursuant to their official duties, the employees are not speaking as citizens and thus are not constitutionally protected from employer sanctions. It further noted that there are whistleblower protection laws (such as the Whistleblower Protection Act) that the plaintiff could have used. *Id.* at 1962. The decision was 5-4. The dissent pointed out that this was likely to silence whistleblowers. *Id.* at 1954.

67. They are awaiting conference committee reconciliation.

68. According to GAP, the Federal Circuit Court of Appeals has effectively gutted protection for whistleblowers by refusing to protect them. Since 1994, the court has only found for one employee on appeal versus 119 against. Press Release, Gov't Accountability Project, *supra* note 64.

69. 263 F. Supp. 2d 684 (S.D.N.Y. 2003).

70. The court held that if Congress intended to override arbitration agreements, it must show that intent in the statute or its legislative history. *Id.* at 685.

71. Earle & Madek argue that the arbitration process will put the interests of the whistleblower and the retaliating employer on the same footing, thus undermining the intent of SOX to give more importance to the rights of whistleblowers. EARLE & MADEK, *supra* note 39, at 35. Preference for whistleblower rights will better carry out the public policy behind SOX.

B. Failure in Spurring Whistleblowing

As a result of the over thirty years of social science research on whistleblowing, it is possible to realistically estimate that SOX's effectiveness will also be limited in terms of getting observers of wrongdoing to come forward.

There are two main models of legislation designed to encourage whistleblowing. The oldest, and least effective, is based on protecting the whistleblower from retaliation. The later model gives incentives to encourage whistleblowing in addition to offering protection.

1. Protective Whistleblower Legislative Model

The model established by the first state and federal statutes to encourage whistleblowing is based on a rational but faulty premise. The model assumes that most observers of wrongdoing are people of conscience who would report the wrongdoing absent the fear of retaliation.⁷² Therefore the statutes ban retaliation in an effort to rid the employees of their fear.⁷³ Studies of these statutes show that they are ineffective in spurring reporting.⁷⁴ Additionally, studies of whistleblower motivation showed fear of retaliation was less important than many other factors in determining whether observers of wrongdoing would come forward to report it.⁷⁵ More important in spurring whistleblowers were serious wrongdoing (either dangerous or involving large sums), strong evidence, the perceived likelihood that the wrongdoing would be corrected, an organizational atmosphere of openness that encouraged voice, and clear reporting channels.⁷⁶

SOX's whistleblowing scheme is based on this protective legislative model. As such, it is unlikely to spur whistleblowing. This is especially true if the wrongdoing involves those high in the organization, as occurred in Enron and WorldCom. Involvement of upper management means that the organization is less likely to respond and encourage voice, and people will be less likely to come forward.⁷⁷ In addition, imposing criminal penalties is unlikely to deter retaliation by those already engaged in wrongdoing.

72. Dworkin & Near, *Whistleblowing Statutes*, *supra* note 57, at 241–247.

73. *Id.* at 259; Dworkin & Near, *Whistleblower Statutes and Reality*, *supra* note 43; Marcia P. Miceli & Janet P. Near, *The Incidence of Wrongdoing, Whistle-Blowing, and Retaliation: Results of a Naturally Occurring Field Experiment*, 2 *EMP. RESP. & RTS. J.* 91, 92 (1989).

74. Miceli & Near, *A Discriminant Analysis*, *supra* note 19, at 698, 700–01.

75. *Id.*

76. Marcia A. Parmerlee et al., *Correlates of Whistle-Blowers' Perceptions of Organizational Retaliation*, 27 *ADMIN. SCI. Q.* 17, 27–31 (1982); *see also* David Hess, *A Business Ethics Perspective on Sarbanes Oxley and the Organizational Sentencing Guidelines*, 105 *MICH. L. REV.* 1781 (2007); Miceli & Near, *A Discriminant Analysis*, *supra* note 19, at 698, 700–01; MICELI & NEAR, *supra* note 15, at 136–78. N.B.: "Voice" is a term of art that means more than just voicing concerns.

77. Callahan & Dworkin, *Media Whistleblowers*, *supra* note 14, at 165–66.

2. Incentive Legislation

In enacting SOX, Congress ignored the overwhelming evidence that merely protecting whistleblowers from retaliation or giving them a cause of action is unlikely to spur whistleblowing. It also ignored the evidence that significant rewards are an effective spur. Indeed, they have been so effective that almost one-third of the states have now adopted reward systems. The model for this approach is not new; it was established in 1863 and was based on earlier English laws.⁷⁸

The federal False Claims Act (“FCA”),⁷⁹ enacted in 1863 in response to contractors cheating the government, was significantly revised in 1986 to make monetary recoveries for whistleblowers easier and more generous and thereby to encourage more whistleblowing in the area of government contractor fraud.⁸⁰ Under the Act, the whistleblower (called a relator) files a *qui tam* suit with the Department of Justice (“DOJ”) on behalf of the U.S. government. If the information is novel and the false claims are proved, the whistleblower receives up to thirty percent of the judgment if the DOJ does not join in the prosecution of the suit, and up to twenty-five percent if it does.⁸¹ Since fraud under government contracts tends to be significant (\$100 billion per year or more), and individual suits can involve millions of dollars, the FCA has proved to be the most significant piece of legislation for spurring whistleblowing.⁸² It is much more effective than merely protecting the whistleblower from retaliation or even giving the whistleblower a private cause of action for retaliation, which is the approach of most state whistleblower legislation. Prior to 1986, there were fewer than six FCA suits brought per year; now there are hundreds. FCA settlements and judgments have totaled over \$17 billion and virtually all whistleblowers have recovered a million dollars or more—even though the majority of suits are settled.⁸³ The first wave of suits tended to involve defense contractors; the second wave, the health care industry.⁸⁴ The next wave may end up involving fraud

78. *Id.* at 155.

79. The FCA is also referred to as the Lincoln Law. Jon Gibeaut, *Seeking the Cure*, A.B.A. J., Oct. 2006, at 44.

80. 31 U.S.C. §§ 3729–3733 (1988).

81. § 3730 (d)(1)-(2).

82. During the 2006 federal government fiscal year, \$3.1 billion was recovered in settlements; Press Release, U.S. Dep’t of Justice, Justice Department Recovers Record \$3.1 Billion in Fraud and False Claims in Fiscal Year 2006 (Nov. 21, 2006), available at http://www.usdoj.gov/opa/pr/2006/November/06_civ_783.html; and in 2002 \$1.1 billion was recovered in *qui tam* actions. Press Release, U.S. Dep’t of Justice, Justice Department Recovers Over \$1 Billion in FY 2002, U.S. Department of Justice (Dec. 16, 2002), available at http://www.usdoj.gov/opa/pr/2002/December/02_civ_720.htm [hereinafter 2002 DOJ Press Release].

83. Of the \$1.1 billion recovered in *qui tam* suits in 2002, \$160 million went to the whistleblowers bringing the claim. 2002 DOJ Press Release, *supra* note 82.

84. In the past few years, the drug industry has been the largest single sector for healthcare fraud. From 2002–2003, the government recovered \$1.98 billion; of that, \$1.33 billion was from the pharmaceutical sector. *Drug Firms Face Whistleblower Worries, Increased Fraud Recoveries*, *Attorneys Say*, 74 U.S. L. Wk. (BNA) 2461 (Feb. 7, 2006).

related to the Iraqi war and Hurricane Katrina. New entities, such as universities, are also being sued under the law.⁸⁵

As of 2006, sixteen states and the District of Columbia, seeing the size and success of recoveries under the federal law and in light of shrinking funds and expanding budgets, have enacted false claims laws that are similar to, and in some respects broader than the federal law. California⁸⁶ and Florida⁸⁷ were the first to pass false claims acts and, as with the federal law, these statutes have resulted in significant recoveries. Some of the state laws apply only to Medicaid fraud; others are general fraud statutes.

Like the federal law, the state statutes provide for a range of recovery, with the judge determining how much the whistleblower should receive. Illinois' distribution system is unique. Its law specifies that one-sixth of the recovery goes to the attorney general, one-sixth to the Department of State Police, and two-thirds to the *qui tam* plaintiff.⁸⁸ The District of Columbia is the most generous; up to forty percent of the recovery can go to the relator.⁸⁹ Factors the courts consider in determining the amount include how substantially the relator contributed to the case, whether the case primarily depended on disclosures from other sources,⁹⁰ and whether the relator planned, initiated, and/or participated in the wrongdoing.⁹¹

Recent legislation shows that Congress is now aware of the effectiveness of incentive legislation. The 2006 Deficit Reduction Act contains a section designed to combat Medicaid fraud and recover federal funds through encouraging states to pass targeted false claims acts.⁹² Congress is particularly interested in encouraging whistleblowing in this area since the federal government pays 60% of Medicaid, and Medicaid fraud far outpaces other federal funds fraud.⁹³ The federal government expects to spend \$192 billion on Medicaid in fiscal year 2006.⁹⁴ The states should be interested because,

85. See, e.g., Jeffrey Selingo, *Expansion of Reasons for Whistle-Blower Lawsuits Should Worry Colleges, Lawyers' Group Is Told*, CHRON. HIGHER EDUC., June 28, 2006; Anne K. Walters, *U.S. Supreme Court Lets Ruling in Whistle-Blower Case Stand*, CHRON. HIGHER EDUC., Apr. 28, 2006, at A33.

86. See CAL. GOV'T CODE §§ 12650–12656 (West 2005).

87. See FLA. STAT. §§ 68.081–.092 (2005).

88. 740 ILL. COMP. STAT. § 175/8 (2004).

89. D.C. Code § 2-308.15(f)(2) (2001).

90. In this case, the relator cannot recover more than ten percent. § 2-308.15(f)(1).

91. Letter from Laurie E. Ekstrand, Dir., Homeland Sec. & Justice, U.S. Gov't Account. Office, to The Honorable F. James Sensenbrenner, Jr., Chairman, Comm. on the Judiciary, House of Representatives et al. (Jan. 31, 2006), available at <http://www.gao.gov/new.items/d06320r.pdf>.

92. 12 U.S.C. § 1441a (2006).

93. Health care fraud is the number one drain on state and federal treasuries. Gibeaut, *supra* note 79, at 46–47. It is by far the main target of current federal *qui tam* actions and represents 46% of the 2,490 claims filed from 1987 to 2005 (compared to 33% for procurement fraud). *Id.* Likewise, recoveries in medical fraud cases by relators have been much larger (\$842 million versus \$291 million in procurement fraud), as have government recoveries (\$5 billion versus \$1.4 billion). *Id.* In a recent case involving Swiss pharmaceutical company Serano, five whistleblowers will split \$51.8 million. *Id.*

94. *Id.* at 48.

beside the usual FCA state recovery of their 40% of Medicaid funds plus fines, if the state law follows the federal model, the states can recover an additional 10%.⁹⁵ A more unique section of the Deficit Reduction Act is the requirement that health care providers give employees education programs on fraud and how to file false claims complaints.⁹⁶ When this law becomes effective in January 2007, it is expected to spur some states to pass false claims acts.⁹⁷

Congress is also looking at rewards to help recover unpaid taxes. The Internal Revenue Service ("IRS"), at the urging of Congress, is in the process of revising its reward system to make it more effective.⁹⁸ The IRS estimates that the "tax gap"—the difference between what is paid in taxes and the estimate of what taxpayers actually owe—is about \$290 billion annually.⁹⁹ The IRS has long had a rewards system but at present rewards are seldom given, are long-delayed, and are given at the discretion of the IRS. Some of the suggested reforms are similar to the 1986 amendments to the FCA, which made it much more effective. These include making awards more certain and faster and giving the whistleblower more information and participation in the process.¹⁰⁰

A different federal approach that encourages whistleblowing through incentives is the Corporate Sentencing Guidelines.¹⁰¹ Unlike the FCA, though, it has not been particularly successful in spurring effective whistleblowing. The Guidelines encourage organizations to establish a whistleblowing procedure that is well-publicized, monitored, and under which complaints are acted on without retaliation to the whistleblower.¹⁰² Compliance results in reduced fines and penalties if the organization is convicted of a crime. Failure to follow these procedures can result in increased sanctions that include large fines, corporate probation, and mandated negative publicity if the organization is convicted of federal crimes.¹⁰³ Hotlines were specifically

95. See *id.* at 46. Even though states can currently share in Medicaid recoveries, the state can get increases through triple damages, too, if they pass the law. *Id.* The HHS issued guidelines in August regarding state compliance with the federal law. *Id.* at 49. Among other things, the state law must allow the case to go forward even if the state decides not to join, whether it allows sealed complaints, and the HHS recommends that the relator should get at least fifteen percent of a recovery. *Id.*

96. *Id.* at 50. Some have complained that the education program undermines stricter company rules and the new Sarbanes-Oxley financial controls. See *id.*

97. See *id.* at 48. Senator Grassley, Senate Finance Committee Chairman and leading sponsor of the legislation, stated, "It ought to be black and white as far as state legislators are concerned. If you are a forward-looking state legislator, you should have passed this years ago, instead of waiting for an incentive from the federal government." *Id.* at 47. The federal legislation was passed after the filing deadline for bills in many states. *Id.* at 48.

98. Tom Herman, *IRS Reworks Its Whistle-Blower Program*, WALL ST. J., June 22, 2006, at D1.

99. *Id.* This is based on 2001 data.

100. See Callahan & Dworkin, *Do Good and Get Rich*, *supra* note 57, at 296–301.

101. U.S. SENTENCING COMM'N, GUIDELINES MANUAL ch. 8 (1991).

102. Callahan & Dworkin, *State Whistleblower Protection*, *supra* note 2, at 103.

103. *Id.*

mentioned as an appropriate whistleblowing procedure, and many companies started using them as a result of this law.¹⁰⁴

Perhaps because of the Guidelines, hotlines have become the dominant mechanism for anonymous SOX whistleblowing.¹⁰⁵ Congress' reliance on anonymity is again based on a faulty premise; fear of retaliation is not dominant in preventing observers of wrongdoing from coming forward. Thus, hotlines are unlikely to spur whistleblowing,¹⁰⁶ but they greatly increase costs in time and money for organizations.

There are several national companies running hotlines. However, these companies describe information about their operations as trade secrets and it is thus difficult to determine their effectiveness. What information is available shows that hotlines and other designated recipients of whistleblowing find that a large percentage of the reports involve human resource issues, and very few involve legal or ethical issues.¹⁰⁷ In order to avoid this problem, some companies limit the topics for which the hotline is to be used.¹⁰⁸ The large number of non-legal reports raises the question of whether all reports should be submitted to the audit committee, or whether reports should be filtered so that only the most important are submitted. The latter course of action raises the possibility that management might be able to block a matter that needed to be forwarded, or that a seemingly minor complaint does not reach the committee and later blows up into a full-scale problem.

Other drawbacks to attempts at facilitating anonymous whistleblowing are that anonymity makes follow-up more difficult and anonymity is often difficult to maintain in light of who has access to the information about wrongdoing.¹⁰⁹ Further, many employees don't trust that their reports will remain confidential and therefore don't use the hotline.¹¹⁰ The inevitable delay caused by reporting outside the organization means that follow-up is delayed, and that evidence may be lost.¹¹¹ One hotline provider reports that even though callers are urged to call back in a few weeks to see if there are

104. *Id.*

105. Companies offering hotlines have expanded greatly since SOX. There are now at least thirty-five companies offering such services. Meg Green, *How's my accounting?*, BEST'S REV., Jan. 1, 2004, at 66.

106. One prominent hotline company reports that calls to its hotline have gone down from seventy-five percent to forty-eight percent over the past twenty years as employees become more comfortable with reporting. Tim Reason, *Whistle-blowers: The Untouchables*, CFO, Mar. 2003, at 18.

107. See, e.g., *Handling the Nuts and Bolts of SOX Compliance*, TEXAS LAWYER, Feb. 7, 2005, at 9.

108. See Bjorhus, *supra* note 22.

109. Donald V. Jernberg, *Whistle-blower hot lines carry own risks*, BUS. INS., June 30, 2003, at 10. The author argues that since companies don't warn employees that anonymity cannot be guaranteed, they may face even broader liability than they would from the retaliation claim itself.

110. *Project: Corporate Counsel—Legal Service Providers: Successful Implementation Of An Ethics And Compliance Training System*, METRO. CORP. COUNSEL (N.E. ed.), Jan. 2005, at 33.

111. Jernberg, *supra* note 109.

additional questions, only about thirty percent do.¹¹² Because of these problems, many experts recommend that hotlines only be used in conjunction with other in-house procedures such as ombudspersons and internet reporting.

III. EFFECTIVE SOX WHISTLEBLOWING

Congress clearly intended whistleblowing to be an important enforcement part of SOX. However, it adopted flawed mechanisms to encourage and protect it. SOX should be reformed to implement a reward system similar to that in the FCA. Observers of wrongdoing should be allowed to bring a sealed claim to court, and if the information is novel and leads to a successful case, the reporter should receive a significant reward.

One source of a reward for SOX whistleblowing, and the easiest, could be a “fee to play” imposed on all companies who list on the exchanges. While it would not be significant for any one company, it could create a sufficient fund, especially if increased by a percentage of recovered fines,¹¹³ to adequately reward whistleblowers for the risks taken in providing the information. However, costs associated with SOX are already cited as one of the main problems with the law, so this fee may not garner adequate support.¹¹⁴

Since the wrongdoing involves fraud or other falsifications, the reward could be based on a percentage of the fraud amount (trebled) plus fines similar to the formula used in the FCA.¹¹⁵ The FCA also has a provision for a fine of up to \$10,000 for each violation.¹¹⁶ A potential problem with this plan is that it is subject to standing challenges because government funds are not usually involved, unlike FCA claims.¹¹⁷ While it is not clear that these challenges would be successful, the issue could be overcome if Congress passed incentive legislation encouraging the states to include securities fraud in their false claims statutes similar to the Deficit Reduction Act discussed above. State entities commonly invest in securities through workers’

112. Green, *supra* note 105.

113. California recently reformed its law to better protect “shareholders, investors, employees and the general public” by encouraging whistleblowing in SOX-type situations. As part of better protection for whistleblowers, the legislators established a fine of up to \$10,000 for employers who violate the statute. See CAL. LAB. CODE § 1102.5 (West 2003 & Supp. 2007).

114. Aaron Lucchetti & Carrick Mollenkamp, *Moving the Market: New York to Study Lack of IPOs*, WALL ST. J., Sept. 27, 2006, at C3; see also, e.g., Kara Scannell & Deborah Solomon, *Business Wins Its Battle to Ease A Costly Sarbanes-Oxley Rule*, WALL ST. J., Nov. 10, 2006, at A1.

115. Professor Pamela Bucy proposed a “Private Justice Cause of Action” in order to protect financial markets. It is similar to the FCA and proposes treble damages of the fraud damages caused. The claim would be brought for the government and the individual bringing it. This is true despite the fact that the government has not been injured by the fraud. Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 105-27 (2002-2003). Rapp, *supra* note 6, at 46-48 (criticizing Bucy’s proposal as subject to constitutional challenge).

116. 31 U.S.C. § 3729 (2000).

117. *But see* Cass R. Sunstein, *What’s Standing After Lujan? Of Citizen Suits, “Injuries,” and Article III*, 91 MICH. L. REV. 163, 232 (1992) (arguing the government can choose to give bounties to help enforce any law).

compensation and pension funds, among other investments, so they would have standing. However, the state would have to argue that the fraudulently induced price for the stock is a claim encompassed by the law.¹¹⁸

Professor Geoffrey Rapp has proposed a different and innovative way to fund SOX whistleblower awards. He suggests amending the Fair Fund provisions of SOX so that the whistleblower is given adequate compensation to make the whistleblowing worth the psychological, emotional, and economic risk.¹¹⁹ The SEC currently has limited power to give rewards but seldom does so and they are often small.¹²⁰ This situation is similar to the IRS scheme that is being revised because of its failed incentives. In order to be most effective, a minimum percentage should be guaranteed to the whistleblower bringing new and useful information.

There is a potential drawback, though, to any scheme that rewards whistleblowing: it would be inconsistent with most foreign whistleblowing legislation. Other countries do not approve of large monetary awards for whistleblowing.¹²¹ This can be cured by providing an exemption for companies operating in countries that have adequate whistleblower schemes and employee protections.¹²² There are already many SOX exemptions for foreign companies, and U.S. courts seem to be moving to limit the international reach of SOX's whistleblowing sections.

A. *The Foreign Reach of Sarbanes Oxley*

While SOX was passed in response to domestic issues, it was written badly and in haste, which, among other things, allowed for potential extraterritorial application.¹²³ The ramifications of the economic and political effects of extraterritorial application lacked adequate consideration. This is true of Section 806, the primary whistleblowing section. This section is broadly written and makes virtually no distinction between domestic and foreign companies that have securities registered or listed in the United States. It has the potential to reach foreign companies and may encompass U.S. employees working abroad. So far there are few judgments on the extraterritorial reach of SOX.

118. See Rapp, *supra* note 6, at 44.

119. *Id.* at 49–50.

120. *Id.* at 4. Rapp suggests this could be done administratively. *Id.* at 49.

121. See Callahan et al., *supra* note 16, at 897–98.

122. The European Commission has proposed its own version of business ethical standards, the Action Plan, as a reaction to SOX. It is seen as a “more multi-dimensional approach, placing shareholder interest as one of a group of protected interests.” Robert Y. Roberts et al., *Spilt milk: Parmalat and Sarbanes-Oxley internal controls reporting*, 1 INT’L J. DISCLOSURE & GOVERNANCE 215, 223 (2004). The International Financial Reporting Standards are also in place for virtually all listed European companies. Thomas Wardell et al., *The convergence of governance*, WORLD FIN., Sept.-Oct. 2005, available at http://www.mckennalong.com/attachment/298/WF_06-01.pdf.

123. Roberts et al., *supra* note 122, at 218; see also Detlev F. Vagts, *Extraterritoriality and the Corporate Governance Law*, 97 AM. J. INT’L L. 289, 289 (2003).

In the first important appellate decision regarding whistleblowing and extraterritorial application of SOX, in January 2006 the First Circuit found that Sarbanes-Oxley did not protect a foreign worker who reported accounting irregularities at a foreign subsidiary of a U.S. corporation.¹²⁴ Boston Scientific Corporation (“BSC”), a Delaware corporation, fired Carnero, an Argentinean citizen working in Brazil for a BSC subsidiary, allegedly for reporting that BSC’s Argentinean and Brazilian subsidiaries were improperly inflating sales figures.¹²⁵ In addition to seeking statutory termination pay in Argentina, Carnero filed a complaint with the U.S. Department of Labor (“DOL”) seeking relief under SOX.¹²⁶ The DOL issued a preliminary decision dismissing his claim, finding that SOX does not apply to employees of covered companies working outside of the United States.¹²⁷ Carnero then filed a complaint with the district court, seeking de novo review. The district court also found no extraterritorial application under these circumstances.¹²⁸

The First Circuit found that Carnero’s allegations likely fit within SOX’s whistleblower protection section,¹²⁹ assuming without deciding that he was an “employee” as defined by the Act, and that his employment was terminated in retaliation for protected conduct.¹³⁰ However, it also found that the law did not have extraterritorial coverage under Carnero’s circumstances.¹³¹ The court concluded that pertinent factors would not support a finding of congressional intent in order to overcome a presumption against extraterritorial application of U.S. laws.¹³² The court described the policy behind the presumption as preventing unintended conflicts between U.S. laws and those of other countries.¹³³ It stated that Congress is “primarily concerned with domestic conditions.”¹³⁴ This statement denies the reality that over a thousand foreign companies list their securities in the United States and voluntarily subject themselves to U.S. laws, and that Congress was assumedly

124. Carnero v. Boston Scientific Corp. (*Carnero II*), 433 F.3d 1, 9 (1st Cir. 2006).

125. *Id.* at 2–3.

126. *Id.* at 3.

127. *Id.* After the DOL decision, Carnero filed a complaint in federal district court, Carnero v. Boston Scientific Corp., No. Civ.A.04-10031-RWZ, 2004 WL 1922132 (D. Mass. Aug. 27, 2004), and also filed a state court claim for breach of contract and retaliatory termination, among others. The district court dismissed the state law claim because Carnero had no contact with Boston Scientific in Massachusetts nor did Boston Scientific direct or control his employment in Latin America. *Carnero II*, 433 F.3d at 4. This decision was upheld by the First Circuit. *Id.* at 2.

128. *Carnero*, 2004 WL 1922132.

129. 18 U.S.C. § 1514A (Supp. 2002).

130. *Carnero II*, 433 F.3d at 6.

131. *Id.* at 18.

132. *Id.* at 8, 18.

133. *Id.* at 7.

134. *Id.* (citing *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991)).

aware of this globalization of the securities market when it enacted SOX.¹³⁵ The court found unpersuasive Carnero's argument that to exempt him from protection would frustrate the basic purpose of SOX which is to protect investors in U.S. securities markets as well as the integrity of the markets. While this "theoretical" protection of investors might be important, it was trumped by the lack of evidence that Congress intended the statute to have extraterritorial effect.¹³⁶ The court contrasted the section under which Carnero was seeking relief with another whistleblowing provision of SOX,¹³⁷ Section 1107, which it stated showed clear congressional intent to apply extraterritorially.¹³⁸

Senator Leahy, in discussing SOX, stated that "[t]he law was intentionally written to sweep broadly, protecting any employee of a publicly traded company who took such reasonable action to try to protect investors and the market."¹³⁹ The *Carnero* court found that Leahy's concern was with the lack of protection under state law and that he did not mean that Section 806 should have extraterritorial application.¹⁴⁰

There have been only a handful of subsequent decisions involving this issue. In *In re Concone v. Capital One Financial Corp.*¹⁴¹ the administrative law judge, citing *Carnero*, found that the complainant, an Italian citizen working only in Italy and England, was not a covered employee under SOX because he was employed outside the United States.¹⁴² In dicta, the judge stated that he saw no reason why SOX would not apply to foreign nationals working in the United States, stating that *Carnero* turned on the fact that Carnero was employed outside the United States and not on his citizenship.¹⁴³

135. The court noted that more than a thousand foreign companies were registered and reporting with the SEC as of Dec. 31, 2003. *Id.* at 5–6. However, it also later said that there was nothing in the legislative history of SOX that indicated that Congress gave any consideration to either the possibility or the problems of overseas application. *Id.* at 8.

136. *See id.* at 7 (“[T]he presumption can be overcome only if there is an ‘affirmative intention of the Congress clearly expressed.’” (quoting *Arabian Am. Oil*, 499 U.S. at 248)).

137. *Id.* at 8. The court found that section 301, which requires audit committees to implement procedures to facilitate anonymous whistleblowing, was not applicable because it conferred no enforceable rights on employees. *Id.* at 10.

138. *Id.* (“That Congress provided for extraterritorial reach as to Section 1107 but did not do so as to Section 806 (the provision relevant here) conveys the implication that Congress did not mean Section 806 to have extraterritorial effect.”). Congress expressly provided for extraterritorial jurisdiction with respect to the provision that Section 1107 amended. *See id.* (citing 18 U.S.C. § 1513(d) (2000) (“There is extraterritorial Federal jurisdiction over an offense under this section.”)).

139. 149 CONG. REC. S1725 (daily ed. Jan. 29, 2003) (statement of Sen. Leahy). Senator Leahy said that he had unique insight because he helped craft the part protecting whistleblowers and worked to get it into SOX on the Senate floor. *Id.*

140. *Carnero II*, 433 F.3d at 11–12.

141. No. 2005-SOX-00006 (ALJ) (Dep't of Labor Dec. 3, 2004).

142. *Id.* at 2–3, 6.

143. *Id.* at 4, n.4.

In another case involving SOX and potential foreign application, *Penesso v. LLC International, Inc.*,¹⁴⁴ the administrative law judge found that a U.S. citizen working abroad could bring a claim under SOX.¹⁴⁵ The plaintiff's claim withstood summary judgment, the judge having found that *Carnero* was not controlling on the issue of extraterritoriality because Penesso was a U.S. citizen working abroad and some of the actions he complained of took place in the United States.¹⁴⁶

Despite good policy arguments and sufficiently broad language in SOX to encompass cases such as *Canero*, consistently limiting the reach of the Section 806 to the United States would help alleviate some of the fears of other countries such as Germany and France. Such countries see the U.S. policy as too broad and believe that confidential transmission of information is preferable to anonymity.¹⁴⁷ The other countries prefer a paper trail so that information can be confirmed, ultimately so that no one can be condemned nor have their reputation sullied without certainty as to the accuracy of the information.¹⁴⁸ In 2005, French and German regulators refused to approve whistleblower mechanisms that McDonald's Corporation and CEAC/Exide (in France) and Wal-Mart (in Germany) sought. These mechanisms would have made the policies in France and Germany coincide with U.S. SOX whistleblower protections.¹⁴⁹ Other European countries joined the debate about these privacy concerns when an E.U. committee composed of privacy experts from the member states proposed on February 1, 2006 a non-binding resolution providing that U.S.-listed companies would have to negotiate such provisions separately with each country.¹⁵⁰ This, of course, would have created tremendous compliance headaches for companies.

B. Exemptions

Several countries have reacted strongly against the external application of SOX.¹⁵¹ While most agree with the tenor of the Act (trying to ensure ethical behavior in business and strengthen the integrity of the markets),¹⁵² they

144. No. 2005-SOX-00016 (ALJ) (Dep't of Labor Mar.4, 2005).

145. *Id.* at 3.

146. *Id.*

147. Among other reasons, they object to SOX whistleblowing policies because they find them reminiscent of Nazism and World War II. See John Gibeaut, *Culture Clash: Other Countries Don't Embrace Sarbanes or America's Reverence of Whistle-Blowers*, A.B.A. J., May 2006, at 10 [hereinafter Gibeaut, *Culture Clash*]. They also place motive above information, and are more distrustful of whistleblower motives. See Callahan et al., *supra* note 16, at 895-96.

148. See Gibeaut, *Culture Clash*, *supra* note 147, at 12.

149. *Id.* at 10.

150. *Id.*

151. The Chinese, for example, have consistently cited the fear of class-action securities lawsuits for deciding to issue stocks abroad; the Europeans the cost of compliance. Murray, *supra* note 9.

152. The stated purpose of the Act is to "restore investor confidence by improving corporate financial reporting." BOSTELMAN, *supra* note 5, at 2-37.

do not necessarily perceive the United States to be at the pinnacle of business acumen nor that U.S. policies should supersede the policies of individual countries, many of which already have corporate governance policies.¹⁵³

The SEC has long made accommodations to facilitate foreign listings on the NYSE and NASDAQ. Perceived benefits of foreign listings include better investor protection under U.S. law, access to capital and increased prestige for the foreign firm, and more income for the exchange.¹⁵⁴ In 1979, the SEC began allowing foreign stock issuers to file some forms and exempted them from some sections relating to proxy rules, tender offer rules, and short swing profit rules to facilitate foreign listings.¹⁵⁵ Later accommodations included the filing of different forms and different disclosure standards. In addition, the SEC has used informal procedures including the confidential treatment of filings and certain disclosures exemptions, and corporate governance issues have tended to be left to the home jurisdictions.¹⁵⁶ As a result, there was a surge of foreign filings in the last decade. The growth was both in numbers, and in countries and areas represented.

The growth has seen a reversal since 2000. Some commentators blame over-regulation,¹⁵⁷ and some particularly cite the cost of SOX compliance for this reduction. At the same time, other exchanges, particularly European, are increasingly an attractive alternative.¹⁵⁸ The SEC has acknowledged the importance of the globalization of the securities market and the concerns of foreign issuers,¹⁵⁹ and has created exemptions to deal with some of these concerns.¹⁶⁰

153. Roberts et al., *supra* note 123, at 218.

154. A fee is required to list on both the NYSE and NASDAQ. *E.g.*, NASDAQ, Listing Standards & Fees (Dec. 2006), http://www.nasdaq.com/about/nasdaq_listing_req_fees.pdf (last visited Jan. 31, 2007).

155. 17 C.F.R. §§ 249.220f, 240.3a12–3(b), 239.31 to 34; Greg Ip, *Is a U.S. Listing Worth the Effort?*, WALL ST. J., Nov. 28, 2006, at C1; Christopher Woo, *The Effects of the Sarbanes-Oxley Act on Foreign Private Issuers* 11 (2007) (on file with author).

156. Woo, *supra* note 155, at 11–12.

157. *See, e.g.*, Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000); Kara Scannell, *Democrat Nods to Wall Street—Rep. Frank Is Flexible on Sarbanes-Oxley, Tougher on CEO Pay*, WALL ST. J., Nov. 4, 2006, at A4; Woo, *supra* note 155, at 2; *see also* authorities cited *supra* notes 8 & 9.

158. Norma Cohen & John Authers, *Euronext seeks rules protection*, FIN. TIMES, June 28, 2006, at 23 (“Euronext is considering creating a special trust to own the licenses of its European exchanges, in a bid to protect itself against any potential move by US regulators to extend their reach across the Atlantic. . . . [I]ssuers and regulators have expressed concern that the provisions of the Sarbanes-Oxley legislation—blamed for the sharp drop in international listings on the NYSE—would be exported to Europe”). Some of these concerns may become moot if the attempted and predicted mergers of exchanges take place. *See* Aaron Lucchetti & Edward Taylor, *NYSE May Ask Deutsche Boerse to Join Euronext Deal*, WALL ST. J., Oct. 4, 2006, at C5; Laura Santini, et al., *Merger Frenzy Among Exchanges Could Be Making Its Way to Asia*, WALL ST. J., Oct. 28, 2006, at B3.

159. *See* Woo, *supra* note 155, at 16 (citing the comments of Commissioner Paul Atkins).

160. *See, e.g.*, Conditions for Use of Non-GAAP Financial Measures, 17 C.F.R. pts. 228, 229, 244, 249 (2006).

For example, the E.U. countries were particularly concerned with Section 103 and the audit committee requirements which they felt conflicted with their own rules. After intense negotiations, an exemption was created for foreign issuers who have an adequate alternative structure that includes the following: a board of auditors that is separate and distinct from the board of directors; no company executive director on the board of auditors; a board of directors that does not appoint the board of auditors; and the country's laws must provide adequate independence of management from the board of auditors.¹⁶¹ Likewise, Section 106, which deals with foreign accounting firms, creates exceptions "tailored to difficulties inherent in U.S. regulation of overseas professionals."¹⁶²

The conflict between whistleblower and confidentiality laws has not been resolved, although it is under discussion between U.S. and European representatives.¹⁶³ If there are blanket exemptions that significantly affect disclosure and transparency, they will undermine some of the advantages of listing on the U.S. exchanges. As noted by Senator Leahy, "[w]hen sophisticated corporations set up complex fraud schemes, corporate insiders are often the only ones who can disclose what happened and why."¹⁶⁴

CONCLUSION

Whistleblowing is gaining recognition worldwide as an important means of ensuring the transparency and integrity of global markets.¹⁶⁵ The contribution of insiders with information about wrongdoing that would be hard to otherwise obtain is growing in importance as organizations become more complex and disparate. Congress recognized whistleblowing's importance by making encouragement of whistleblowing and protecting whistleblowers an integral part of Sarbanes-Oxley. Congress should now take the next step to make the law more effective by creating a reward system similar to that under the False Claims Act. The reward incentive is the only scheme in the United States that has proved effective in encouraging enforcement through whistleblowing. The risk of abuse through class action derivative suits is reduced by

161. See Maria Camilla Cardilli, *Regulation Without Borders: The Impact of Sarbanes-Oxley on European Companies*, 27 *FORDHAM INT'L L.J.* 785, 801-02 (2004).

162. *Carnero v. Boston Scientific Corp.*, 433 F.3d 1, 9 (1st Cir. 2006) (citing 15 U.S.C. § 7216(c) (Supp. II 2002) which states that the SEC or the Public Company Accounting Oversight Board may, as it "determines necessary or appropriate in the public interest or for the protection of investors' exempt the foreign firm from the Act").

163. Gibeaut, *supra* note 79.

164. 148 *CONG. REC.* S6439-40 (daily ed. July 9, 2002) (statement of Sen. Leahy).

165. See Annette L. Nazareth, *Keeping SarbOx Is Crucial: Some U.S. critics call it burdensome, but other nations are adopting similar laws*, *BUS. WK.*, Nov. 13, 2006, at 134; see also Ip, *supra* note 155.

requiring that the reward be based on new information, the government review of the claim, and the detailed pleadings that would be involved.¹⁶⁶

Additionally, the statute of limitations on bringing claims should be significantly expanded in order to give employees adequate time to report. Further, the legislation should specifically state that fraud claims and retaliation claims trump arbitration clauses.

If these reforms are instituted, limited exemptions from the whistleblower sections of SOX should be created for foreign companies who operate in countries that have their own schemes to protect employees from retaliation. This will avoid undue conflict with the laws of foreign countries whose companies are listing on the exchanges. It is possible for the United States to maintain the integrity of its markets while being a global player.

166. See Rapp, *supra* note 6, at 9–14. In response to these perceived problems, Congress passed the Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).