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Materiality in Sarbanes-Oxley Act Employee Protection Claims

By William Dorsey*

*A corporation is just like any natural person, except that it has no pants to kick or soul to damn, and, by God, it ought to have both!
A Western Judge

The Sarbanes-Oxley Act of 20022 embodies a recent legislative effort to rein in corporate excesses in a history that stretches back at least to the spread of state blue sky laws and the enactment of the federal antitrust acts early in the twentieth century.3 With the Act Congress firmly planted its foot at the back of the pants of public company boards, their managers, public accounting firms and lawyers, after a succession of high-profile corporate accounting and other scandals. Fully aware that the dominant business culture it was determined to reform loathed as traitors all who disclose

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wrongdoing, Congress included new whistleblower protections among its remedies. This article explores an aspect of that measure—whether the information an employee discloses must meet a “materiality” test to confer job protection—and argues that it does not.

Commercial wrongdoing filled the news in 2001 and the first seven months of 2002 as Enron, Global Crossing, WorldCom (now MCI), and Adelphia Communications imploded; all eventually would file for bankruptcy. Financial statements of Qwest Communications International Inc. falsely characterized $2 - $3 billion in fiber-optic capacity sales as recurring instead of one-time revenue, as an expedient to meet aggressive Wall Street targets for revenue and earnings growth. Bristol-Myers Squibb inflated its 2001 revenue by $1.5 billion because it muscled its wholesalers to accept more inventory than they could sell, to get it off Bristol’s books. A long list of major energy firms including CMS Energy, Duke Energy, Dynegy, El Paso, and Reliant Resources made “round-trip” trades to artificially boost their sales volume, cash flow and (or) revenue. Tyco International was looted by the trio of its CEO, CFO, and General Counsel. The S&P 500 index sank 31% between the beginning of 2002 and July 23, 2002.


5. The Senate Report, supra.


leaders, corporate accounting and reporting practices, certified public accountants and lawyers plummeted.

Approved in the House by a vote of 423-3 and in the Senate 99-0 on July 25, 2002, the Sarbanes-Oxley Act established new or enhanced standards that apply to U.S. publicly traded companies, their managers, auditors and lawyers. Changes within the Act's 11 provisions that set the new business milieu include:

- Boards of publicly traded companies must choose audit committees of independent directors who become responsible to appoint, compensate, and oversee the companies' outside auditors.\(^9\)

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10. Title III, § 301 of the Sarbanes-Oxley Act, adding 15 U.S.C. § 78f(m)(2) to the Securities Exchange Act of 1934. This policy had its genesis in the February 1999 recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees, established jointly by the Securities Exchange Commission, the New York Stock Exchange, and the National Association of Securities Dealers. Id. Concerns arose about the financial literacy of board members, their independence from management and ultimately the adequacy of the oversight managers received from their corporate boards. Id. It was unclear whether boards or their audit committees were guiding the subjective judgments which managers and auditors made about things such as estimates, elective accounting principles, and new significant transactions embedded in public companies' financial reports. In Recommendations 4 and 6, the Blue Ribbon Committee proposed that as the shareholders' representatives, the audit committees ought to have written charters from their boards, explicitly stating that the outside auditors are responsible to the board of directors through the audit committee, who are the authorities responsible to choose the outside auditors, to assess their performance, and even to replace them should it become necessary. Id. The Committee determined that (1) in most companies management rather than the board of directors selected outside auditors (or recommended auditors in proxy statements for shareholder approval), negotiated fees, and monitored the audit, and “[c]onsequently, the outside auditors typically develop over time close relationships with management,” and (2) “the expanding role of outside auditors, particularly in providing non-audit services, has further entwined the relationship of management and the outside auditors.” Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, at 29-33, discussing Recommendations 4 and 6.

By late 1999 to early 2001 the Blue Ribbon Committee’s proposals had been adopted as listing requirements by the major stock exchanges. See Securities Exchange Act Release No. 42233 (December 14, 1999), 64 FR 71529 (December 21, 1999) (NYSE); No. 42231 (December 14, 1999), 64 FR 71523 (December 21,
• Previously company managers—typically the chief financial officer (CFO)—hired and could fire the outside auditor, which led auditors to treat management as the client;\(^\text{11}\) Senior corporate officers must personally certify the accuracy of quarterly and annual corporate accounting filed with the Securities and Exchange Commission (SEC), ending the era of “I’m not an accountant” CEO excuses;\(^\text{12}\)


12. Members of Congress were thunderstruck by Jeffery Skilling’s testimony that he believed the company was in good shape when he left as Enron’s CEO. See A New Sheriff, supra note 6, and the text accompanying nn. 10 and 112. A 1999 study of a decade of financial statement fraud by companies with SEC-registered securities had found that the chief executive officer was involved in 72% of those frauds, and the chief financial officer in 43% of them. See COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies 20 (1999). Title III, § 302 of the Sarbanes-Oxley Act required the SEC to adopt rules mandating that both the CEO and CFO of covered publicly traded companies certify that each of the entity’s periodic “financial statements fully complies with the requirements of § 13(a) or § 15(d) of the Securities Exchange Act of 1934 [15 U.S.C. 78m or 78o(d)]” and that information contained in each periodic report “fairly present[s], in all material respects, the financial condition and results of operations of the issuer.” The SEC did so in Rules 13a-14 and 15d-14 (17 CFR §§ 240.13a-14, 240.15d-14). The certification covers not only the financial statements (including footnotes), but also management’s discussion and analysis of the financial condition and results of operations, and any other financial information the report contains. Ignorance is no defense to falsely certifying a quarterly or annual report if the CEO should have known the certification was false. A false certification subjects the CEO or CFO to a SEC enforcement action for violating §
• Executives who knowingly and willfully certify false financial statements to the SEC,¹³ and those (especially accountants) who destroy audit or other records so they will not be available for use in official proceedings risk large fines and significant prison terms;¹⁴

• Accountants lose control over accounting standards for securities issuers; that authority was transferred to a new 5-member quasi-public body, the Public Company Accounting Oversight Board, whose majority cannot be certified public accountants;¹⁵

• Attorneys who appear and practice before the SEC must adhere to minimum standards of professional conduct the SEC would set in rules,¹⁶ and

¹³(a) or § 15(d) of the Securities Exchange Act and to actions by the SEC and investors for violating § 10(b) of the Securities Exchange Act [15 USC § 78j(b)] and Exchange Act Rule 10b-5 (17 C.F.R. § 240.10b-5).

¹³. Title IX, § 906 of the Sarbanes-Oxley Act, codified at 18 U.S.C. § 1350 (2002), imposes stiff criminal fines of up to $5,000,000 and twenty-year prison terms on those chief executive and chief financial officers who willfully and knowingly certify to the SEC inaccurate financial statements.

¹⁴. Title VIII, § 802 of the Sarbanes-Oxley Act, codified as 18 U.S.C. § 1520(a)(1) (2002), deals particularly with destruction of accountants' audit or review work papers, and Title XI § 1102, codified at 18 U.S.C. § 1512(c), deals with destruction of other records, documents, or objects.

¹⁵. Title I, § 101(c) of the Sarbanes-Oxley Act creates the Public Company Accounting Oversight Board. The Board is empowered to set auditing, quality control, ethics, independence and other standards for audit reports that registered accounting firms issue on the financial statements prepared by issuers of securities. See James D. Cox, Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements, 81 WASH. U. L.Q. 301 (2003). The Board’s web site states that as of May 15, 2007, 1,783 accounting firms have been registered, http://peaobus.org/Registration/Registered_Firms_pdf.

¹⁶. Title III, § 307 of the Sarbanes-Oxley Act, codified as 15 U.S.C. § 7245. These controversial SEC rules are codified at 17 C.F.R. Part 205. The Commission reaffirmed that its rules “shall prevail over any conflicting or inconsistent laws of a state or other United States jurisdiction in which an attorney is admitted or practices.” See the IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT
Companies listed by national stock exchanges and national securities associations must establish procedures for their audit committees to receive, assess and retain complaints about accounting, internal accounting controls, or auditing matters, including confidential, and anonymous submissions from employees.\textsuperscript{17}

An equally significant innovation in Title VIII, § 806\textsuperscript{18} of the Sarbanes-Oxley Act shields employees in publicly traded companies from job retaliation when they voice concerns that relate to enumerated anti-fraud laws and to SEC rules. Congress enlisted the aid of employees to expose unethical and illegal business practices internally or externally, before they escalate into financial crises.\textsuperscript{19} This sort of bottom-up internal monitoring has been called employee “undersight.”\textsuperscript{20} Fraud examiners know the value of employees as fraud tipsters; over 40% of corporate fraud is discovered through employee tips.\textsuperscript{21} The statute forbids any covered employer to discriminate against an employee who provides information to a


17. Title III, § 301 of the Sarbanes-Oxley Act, adding 15 U.S.C. § 78j-l(m)(4) to the Securities Exchange Act of 1934. The SEC implemented it with 17 C.F.R. § 240.10A-3(b)(3), that requires audit committees to adopt formal procedures to handle employee complaints, but eschewed a “one size fits all” approach to what those procedures should encompass. See Standards Relating to Listed Company Audit Committees, Release Nos. 33-8220 & 34-47654, 68 Fed. Reg. 18,788 at 18,798, and the text accompanying nn. 110-11 (Apr. 16, 2003). The ability to submit anonymous complaints knowing that independent members of the board of directors who make up the audit committee must investigate them may encourage whistleblowing.


19. The potential benefits employees can provide as corporate monitors are discussed in Richard E. Moberly, Sarbanes-Oxley’s Structural Model To Encourage Corporate Whistleblowers, 2006 BYU L. REV. 1107, 1113-25 (2006).


21. Id. at 154 & n.72, (citing the Association of Certified Fraud Examiners, 2004 Report to the Nation on Occupational Fraud and Abuse, at 20.).}
supervisor, federal executive agency, or to the legislative branch, or who assists in an investigation of something the employee reasonably believes to be mail fraud,\textsuperscript{22} wire, radio or TV fraud,\textsuperscript{23} bank fraud,\textsuperscript{24} securities fraud.\textsuperscript{25} Covered employees are also forbidden from violating any rule or regulation of the SEC\textsuperscript{26}, or any provision of federal law relating to fraud against shareholders.\textsuperscript{27}

Congress never restricted these employment protections to disclosures about large schemes that courts would regard as having a quantitatively material bearing on the accuracy and completeness of a publicly traded company’s financial statements. Some decisions of administrative law judges at the U.S. Department of Labor and one recent decision by the Department’s Administrative Review Board risk making the error of conditioning whistleblower protection in Sarbanes-Oxley matters on the “materiality” of the information the employee discloses. Materiality analysis often tips the result in other kinds of litigation involving securities and corporate fraud. Nothing in the text or legislative history of the employment protection provision equates it to a prosecution for securities fraud or white collar crime.

\begin{itemize}
  \item \textsuperscript{22} 18 U.S.C. § 1341.
  \item \textsuperscript{23} 18 U.S.C. § 1343.
  \item \textsuperscript{24} 18 U.S.C. § 1344.
  \item \textsuperscript{25} 18 U.S.C. § 1348.
  \item \textsuperscript{26} 18 U.S.C. § 1348.
\end{itemize}
This article argues that information an employee discloses need not satisfy a “materiality” requirement under the federal securities laws, such as § 10(b) of the Securities Exchange Act of 1934, to obtain protection under 18 U.S.C. § 1514A(a)(1). Nor is some sort of materiality required under any of the other predicate statutes. Narrowing the protections by introducing materiality thresholds defeats the intent of Congress.

To develop this argument, the employee protection provisions of the Sarbanes-Oxley Act will be laid out in Part I. Then differences in how the evidence code, securities litigators, auditors, the Securities and Exchange Commission (SEC), and the general public use the term “materiality” will be explored in Part II. The cause of action elements for securities fraud and a whistleblower claim are contrasted in Part III. To determine the breadth of the protections Congress meant to confer on corporate employees the statutory text and legislative history of the Act will be considered in Part IV. The Secretary of Labor’s refusal to codify a quantitative measure of materiality will be reviewed in Part V, and the decisions of the Department of Labor’s administrative law judges and the Administrative Review Board that discuss materiality and accounting issues will be surveyed in Part VI, with special attention to the Board’s decision in Platone v. FLYi, Inc.28

I. THE ACT’S WHISTLEBLOWER PROTECTIONS

The Sarbanes-Oxley Act includes civil and criminal penalties for those who retaliate against corporate whistleblowers. Congress generally patterned the civil safeguards on statutes which the U.S. Secretary of Labor administers to protect employees of Nuclear Regulatory Commission licensees and their contractors who have raised nuclear safety complaints from retaliation,29 and to protect employees of air carriers and their contractors who have raised air safety complaints.30

Workers employed directly by a publicly traded corporation or by its contractors are protected when they inform their supervisors or

government officials in the executive and legislative branches about misconduct, and when they participate in SEC proceedings or shareholder litigation. The core of the civil whistleblower statute says:

Sec. 1514A. Civil action to protect against retaliation in fraud cases

(a) WHISTLEBLOWER PROTECTION FOR EMPLOYEES OF PUBLICLY TRADED COMPANIES- No company with a class of securities registered under § 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under § 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee--

(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of §§ 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by--

(A) a Federal regulatory or law enforcement agency;

(B) any Member of Congress or any committee of Congress; or

(C) 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); or

(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of §§ 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange
Commission, or any provision of Federal law relating to fraud against shareholders.

The provision goes on to incorporate explicitly the airline statute’s procedures. Relief a successful whistleblower receives includes reinstatement with lost seniority, back pay with interest, compensatory damages, costs and attorneys fees.

The Secretary’s regulations that implement these protections describe four essential elements of the claim: (1) a covered employee engaged in a protected activity; (2) the employer knew or suspected that the employee engaged in some protected activity; (3) the employee suffered an unfavorable personnel action; and (4) the circumstances raise the inference that the protected activity was a factor that contributed to the unfavorable employment action.

The Act also amends the federal obstruction of justice statute. Those who knowingly retaliate against a person who provides truthful information to a law enforcement officer about the possible commission of a federal offense (including interfering with the person’s employment) may be fined and imprisoned for up to ten years. Unlike the civil liability provision that this article focuses on, the criminal statute does not confine its protection to employees of publicly traded companies—it extends to all employees. Bridging criminal and civil liability, the offense of obstructing justice also qualifies as a predicate for civil Racketeering Influenced and Corrupt Organizations Act (“RICO”) liability. Those prosecutions and proceedings do not involve the Secretary of Labor, however, and will not be discussed further.

36. The amendments to the criminal code and directions to the United States Sentencing Commission to revise the sentencing guidelines for major securities frauds are analyzed in Kathleen F. Brickey, From Enron To Worldcom And Beyond: Life And Crime After Sarbanes-Oxley, 81 WASH. U. L.Q. 357 (2003).
Having seen what the statute covers, the next step is to explore what “materiality” can mean.

II. MATERIALITY

“Materiality” is a term layered with connotations. Is it “materiality” as the Federal Rules of Evidence and the Department of Labor’s version of those rules conceive it, as securities fraud litigators use it, or as certified public accountants apply it when they give their imprimatur to the accuracy of management’s financial statements? None use it in quite the same way, and the differences may not be meaningful to laymen.

A. Under the Federal Rules of Evidence

Materiality, an aspect of relevance, deals with whether the evidence helps to prove some proposition at issue in the litigation. Materiality is not defined in the Federal Rules of Evidence (or the OALJ version of those rules38), but the concept is implicit in them. The applicable rule says:

Relevant evidence” means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence.39

Any fact that is “of consequence” is a material fact. This federal definition drew on California Evidence Code section 210, which was thought to have “the advantage of avoiding the loosely used and ambiguous word ‘material.’”40

37. 1 MCCORMICK ON EVIDENCE § 185 (6th ed. 2006).
38. Codified at 29 C.F.R. Pt. 18(b).
40. See 9 C.F.R. § 18.401 advisory committee’s note.
B. In Securities Fraud Litigation

The text of the civil Sarbanes-Oxley whistleblower protection provision never mentions materiality. The concept lurks about because the statute's protections apply to employees of publicly traded companies. "Material" is a term that matters in securities fraud litigation, commonly brought under the investor protection provisions of § 10(b) of the Securities Exchange Act of 1934.\textsuperscript{41} The well-known SEC Rule codified at 17 C.F.R. § 240.10b-5 implements that statute. The narrow understanding of materiality the Article III courts exhibit in those cases would be foreign to an auditor.

Three parts of Rule 10b-5 describe prohibited conduct. Its second part proscribes the making of "any untrue statement of a material fact" or the omission of any material fact that is necessary in order to render the statement not misleading.\textsuperscript{42} The first and third parts make it unlawful for any person "to employ any device, scheme, or artifice to defraud" or "to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."\textsuperscript{43} These reflect the fraud and scienter element of securities litigation.

Materiality often becomes the central issue in those cases. In the Southern District of New York where many of these causes of action are filed, district judges have held in motions to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure that for an alleged misstatement or omission to be immaterial, it must be "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of [its] importance."\textsuperscript{44}

A district court nonetheless dismissed a securities fraud complaint with prejudice in \textit{In re Duke Energy Corp. Sec. Litigation}.\textsuperscript{45} The plaintiff alleged that Duke Energy had failed to

\textsuperscript{41} 15 U.S.C. § 78j(b).
\textsuperscript{42} SEC Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b) (emphasis added).
\textsuperscript{43} Rule 10b-5(a) & (c), 17 C.F.R. § 240.10b-5(a) & (c).
adequately disclose that it had overstated its revenues due to "round trip" or "wash transactions," where simultaneous sales and purchases of energy occur at the same prices and in the same amounts. The stock price dropped when the company confirmed in August 2002 that it had engaged in $217 million of these transactions. Regulatory problems the SEC found with the way Duke Energy operated that energy trading unit led to a cease-and-desist order discussed in Part II (C)(3)(b), below.

The district court found that concealment of these trades could not have been material. An inflation of $217 million in Duke Energy’s revenues over a two-year period amounted to about 0.3% of the company’s total revenues—a total that the court found immaterial as a matter of law. The plaintiffs made two counterarguments that the court rejected as insufficient.

First, the plaintiffs argued that the drop in the share price after the announcement that these trades had been discovered demonstrated that investors thought they were material. The court disagreed because: (a) the plaintiffs’ allegations that stock price decline was caused by or directly connected to the company's financial disclosures were too vague; and (b) "bare allegations of stock price declines cannot cure the immateriality of an overstatement as small as the one here at issue."

Second, the plaintiffs argued that the nondisclosure was qualitatively material because it involved illegal activities. Even if the transactions were assumed to be illegal, the court believed the failure to disclose them did “not give rise to a securities claims if

46. A recent Government Accountability Office study defined “round trips” as “transactions with non-related parties that artificially inflate volume and revenues, through the simultaneous purchase and sale of products between colluding companies.” U.S. Government Accountability Office, Financial Restatements Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities (GAO-06-678), as reissued on March 5, 2007, at 19 (Table 2–Financial Restatement Category Descriptions).
47. 282 F. Supp. 2d at 160.
48. Id. at 161.
49. Id.
50. Id.
51. Id.
their only effect in terms of what was disclosed to the public was a miniscule 0.3% inflation of revenues.”

Perhaps the most important observation the Duke Energy Corp. Court made for present purposes was that:

Plaintiffs are ‘vague about what constituted this underlying ‘illegality,’ as ‘wash sales’ and ‘round-trip trading’ are not necessarily illegal per se. But even assuming they were, illegality of a financial nature (as opposed, say, to rape or murder) must still be assessed, for disclosure purposes, by its economic impact. Otherwise, every time a giant corporation failed to disclose a petty theft in its mailroom, it would be liable under the securities laws (emphasis added).”

Duke Energy’s traders and managers inflated trading volumes for some reason, or they would not have bothered with those trades; manipulation of revenue in financial reports seems the obvious purpose. The district court’s approach denigrates qualitative materiality, by focusing almost exclusively on the magnitude of investor losses in the market traceable to chicanery. The Third Circuit goes so far as to treat a misstatement as immaterial as a matter of law when it does not affect the market price for the stock. It holds that the materiality “may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm’s stock.” The Ninth Circuit, in contrast, holds that a misrepresentation may be material even if the market fails to react to it, and the determination is not purely a legal matter, but demands a fact-specific inquiry.

52. Id. (emphasis added).
53. In re Merck & Co. Sec. Litig., 432 F.3d 261, 269 (3rd Cir. 2005) (affirming the dismissal of the claim on a Rule 12(b)(6) motion where a Merck subsidiary had recorded $12.4 billion in consumer-to-pharmacy co-payments over three years that the subsidiary had no rights to and never collected). Given how few shares are sold short in the market, the Third Circuit’s assumption that securities markets are actually efficient is debatable, not self-evident. See Jonathan R. Macey, A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules, 81 WASH. U. L.Q. 329, 346-49 (2003).
54. No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920 (9th Cir. 2003) (reversing the dismissal of a
Then-Chairman of the SEC Arthur Levitt described succinctly the weakness that inheres in the approach the Duke Energy Corp. court took:

But some companies misuse the concept of materiality. They intentionally record errors within a defined percentage ceiling. They then try to excuse that fib by arguing that the effect on the bottom line is too small to matter. If that's the case, why do they work so hard to create these errors? Maybe because the effect can matter, especially if it picks up that last penny of the consensus [earnings] estimate. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly .... ‘It doesn’t matter. It’s immaterial.’ In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called non-events simply don’t matter.55

Equity compensation compounds the problem, driving senior management schemes to hit earnings targets to maximize the value of stock options.56 The value of stock options the two thousand largest corporations granted their executives increased from $50 billion in shareholders suit that alleged an airline made misleading statements while it knew that costly regulatory sanctions were about to be imposed on it; the market did not react immediately to the imposition of those sanctions, but that did not disprove materiality, for the market reacted when the full cost implications of the penalty were announced.).


56. Id. Decrying managers made efforts “to meet or beat Wall Street earnings projections in order to grow market capitalization and increase the value of stock options.” See also Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U. CHI. L. REV. 1233, 1247 (2002) (“So managers with a rich load of options have incentives to get the stock price high by any means necessary, fraud included.”).
Professor John Coffee of Columbia University Law School offered this thought experiment: Suppose that in early 2001 the compensation package for the CEO of a corporation granted him options on two million shares of company stock then trading at a price-to-earnings ratio of 30 to 1—reasonable assumptions for the time, when Enron shares sold at an exuberant seventy times earnings.\(^5\) If the CEO can prematurely recognize revenue to increase earnings to \$1 over analysts’ estimates, the stock price should jump an unmerited \$30 per share, and leave him \$60 million richer.\(^6\) Is it surprising that the president may yield to the temptation?

“Undersight” by whistleblowing employees aware of the CEO’s accounting trickery provides one (although a weak) counterbalance to such potent incentives to fraud. Information whistleblowers disclose could spark a restatement of the company’s financial statements, which today triggers draconian financial penalties for the CEO and CFO under § 304 of the Sarbanes Oxley Act.\(^6\) On the other hand,

59. GATEKEEPERS, supra note 57, at 62-63.
60. Codified as 15 U.S.C. § 7243. That provision requires that when misconduct results in a company’s violation of financial reporting requirements that calls for a restatement of its financials, the CEO and CFO must reimburse the company for any bonus or other incentive-based or equity-based compensation either of them received during the 12-month period following the filing of the erroneous financials with the SEC, and pay the company any profits realized from the sale of the company’s securities during that period. The SEC is empowered to exempt the officers from the penalty in an appropriate case. The statute seems to impose strict liability on the CEO and CFO, similar to the insider short-swing trading prohibition found in §16(b) of the Securities Exchange Act [15 U.S.C. § 78p(b)], even if they were not the parties guilty of “misconduct.” See Richard E. Wood, Bad Boys (and Girls) Get Clawed Back, 18 BENEFITS L.J. 84, 95 (Summer 2005).

The company may be able to bring an action for the disgorgement, In re Qwest Communications Int’l, Inc. Sec. Litig., 387 F. Supp. 2d 1130, 1150 (D. Colo. 2005), but the statute creates no private right of action that shareholders can enforce in a derivative suit. In re Digimarc Corp., 2006 WL 2345497, *3 (D. Or. 2006); Kogan v. Robinson, 432 F. Supp. 2d 1075 (S.D. Cal. 2006); In re BISYS Group Inc. Derivative Action, 396 F. Supp. 2d 463 (S.D.N.Y. 2005); Neer v. Pelino, 389 F. Supp. 2d 648 (E.D. Pa. 2005). Assumedly the SEC could sue to enforce the disgorgement provision, but it has yet to do so, perhaps because it has
whistleblowers may become important allies of innocent CEOs and CFOs, who now have personal incentives to scour every available source to learn about fraud, before it becomes a problem big enough to initiate a restatement that threatens their past compensation.

Actual loss to those who invested in the employer’s securities is not an element of an employee’s whistleblower protection claim, which focuses on damages to the employee, not to investors. Any employee who exposed the accounting fraud that triggered incentive pay may well need protection from the CEO’s wrath. However, exposing lesser frauds may require no less protection.

C. In Public Accounting

The accounting profession does not take the judicial market-based approach to materiality. Indeed it could not, because its opinions about whether management’s financial statements fairly present the financial condition of the enterprise form a vital part of the robust, reliable and fairly distributed information that efficient markets are thought to immediately incorporate into stock prices. This section will examine other remedies to draw on, such as § 1103 of the Sarbanes Oxley Act [15 U.S.C. § 78u-3(c)] that authorizes it to obtain an order in district court freezing extraordinary payments to executives.

Public companies are now adding language in executive compensation agreements to claw back cash bonuses and stock awards from those executives whose jobs are to ensure the accuracy of the company’s financial statements, and who receive incentive compensation based on the information included in those financial statements, if fraud or misconduct leads to a financial restatement. See Executive Compensation and Related Person Disclosure, SEC Release Nos. 33-8732A, 34-54302A & IC-27444A (Aug. 29, 2006); 71 Fed. Reg. 53,158 at 53,166 & text accompanying note 83 (Sept. 8, 2006).

61. 18 U.S.C. § 1514A.

62. In an efficient market the stock price fully reflects all publicly available information so quickly that ordinary investors cannot make trading profits from new information. In re Xcelera.com Sec. Litig., 430 F.3d 503, 508 (1st Cir. 2005); see also Cammer v. Bloom, 711 F. Supp. 1264, 1285-87 (D.N.J. 1989) a leading decision that developed a five-factor test for market efficiency that considers: (1) the stock’s average weekly trading volume, (2) the number of securities analysts who follow the stock, (3) the number of market makers and arbitrageurs active in the stock, (4) the company’s eligibility to file an Form S-3 registration statement with the SEC, and (5) any historical cause-and-effect relationship between company disclosures or unexpected events and an immediate response in the stock’s price.
the concept of materiality as the Financial Accounting Standards Board, the Auditing Standards Board of the American Institute of Certified Public Accountants, and the SEC treat it in their authoritative pronouncements.

To certified public accountants, materiality has quantitative and qualitative facets. They use the term "materiality" to describe matters that contribute to their primary concern: whether management’s financial statements, taken as a whole, present fairly the financial position of the company, the results of its operations, and its cash flows, in conformity with United States generally accepted accounting principles. Using the logic of diminishing returns, auditors recognize that some items do not merit the time and trouble of precise measurement and reporting. They treat them as "material" when there is a substantial likelihood that a reasonable person would consider the information important. They also dispense with them as immaterial if potential investors, lenders or others would think them too trifling to affect investment, credit or similar decisions. But bitter experience has taught the accounting profession that some manipulations of corporate accounts, like bogus revenue recognition,63 is such a harbinger of accounting fraud that if it is uncovered,64 auditors indulge a working assumption that the fact of the misstatement itself has a qualitatively material effect on the fairness of the financial statements management presents to them.

63. A General Accounting Office study determined that inappropriate revenue recognition was responsible for 39% of the 919 restatements of prior period financial results it identified that 845 companies made in the period from January 1, 1997 to June 30, 2002. See U.S. General Accounting Office, Financial Statement Restatements—Trends, Market Impacts, Regulatory Responses, and Remaining Challenges (GAO-03-138), October 2002 at 5, 19 and Fig. 3. When the GAO updated its study in 2006, revenue recognition problems still accounted for 20% of prior period financial restatements from July 2002 to September 2005. U.S. Government Accountability Office, Financial Restatements Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities (GAO-06-678), as reissued on Mar. 5, 2007 at 17 (Fig. 4) and 18.

64. See Joseph T. Wells, So That’s Why It’s Called a Pyramid Scheme, J. OF ACCOUNTANCY 91 (Oct. 2000). “The most common way companies create fictitious revenues is to dummy up sales that did not occur. The accounting transaction created is a credit to sales with an offsetting debit to accounts receivable, which boosts both assets and income.” Id.
1. Financial Accounting Standards Board

Statement of Financial Accounting Concepts No. 2, of the Financial Accounting Standards Board (FASB) encapsulates the concept of materiality in one sentence:

The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.65

This characterization by the accounting profession is similar to the U.S. Supreme Court’s statement that a fact is material under investor protection laws if there is:

a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available. 66

The FASB rejects a formulaic approach to discharging what it acknowledges is a certified public accountant’s “onerous duty of making materiality decisions.”67 It favors an approach that takes all relevant considerations into account before reaching any judgment about materiality.68 In doing so, FASB makes clear that “magnitude by itself, without regard to the nature of the item and the

68. Id.
circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.  

The FASB approach sounds a great deal like one of the law’s “totality of the circumstances” tests; it considers:

- quantitative indicators, including the size of the matter at issue both in dollar or percentage terms, plus
- qualitative indicators, such as whether the managers of the enterprise intentionally over- or under-stated an amount in a financial or a related statement just short of a percentage threshold, in an effort to manipulate how the information would be regarded by those relying on it.

2. The AICPA

The American Institute of Certified Public Accountants (AICPA) develops binding professional auditing standards through its Auditing Standards Board (Board). The newly created Public Company Accounting Oversight Board (PCAOB) adopted most of those pre-existing auditing standards as its interim auditing standards on a transitional basis on April 16, 2003.70

As part of its series of Statements on Auditing Standards (SAS), the Board recently issued SAS No. 107, “Audit Risk and Materiality in Conducting an Audit.”71 In it the Board specifically recognizes that qualitative and quantitative factors interact as an auditor makes judgments about materiality; misstatements that involve relatively small amounts nonetheless may have material effects.72 This is particularly true when the misstatements would increase management’s compensation (by satisfying the requirements to qualify for incentives), or involve fraud, possibly illegal acts, violations of contractual provisions, or conflicts of interest.73

69. Id. ¶ 125.

70. PCAOB Rule 3200T describes the auditing standards that the PCAOB adopted and requires registered public accounting firms to comply with these auditing standards as they audit public companies to the extent they are not superseded or amended by the Board. See www.pcaobus.org/standards.


72. SAS No. 107, ¶¶ 59-61.

73. Id. ¶ 60(f), (g).
Not long after the Sarbanes-Oxley Act became effective, the Board issued SAS No. 99, "Consideration of Fraud in a Financial Statement Audit," effective October 2002, which includes obligations that auditors:

- Assess the risk of material misstatement due to fraud,
- Design audit procedures that respond to the assessed risk of fraud, and
- Determine when a separate fraud investigation engagement is necessary.

Many fraudulent financial reporting schemes have involved the improper recognition of revenue, often to inflate quarterly or annual earnings. Companies forced to make restatements of their financials due to improper revenue recognition:

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75. FASB Concepts Statement No. 6, Elements of Financial Statements, defines revenue at ¶ 79 as “actual or expected cash inflows (or the equivalent) that have occurred or will eventuate as a result of the enterprise’s ongoing major or central operations.” Premature revenue recognition occurs when the business books income before a sale is complete, before a product is delivered to a customer, or at a time when the customer still has the right to terminate, void or delay the sale; defers accounting for discounts, rebates, or guarantees; engages in “round-trip” transactions or channel stuffing; or treats swaps as revenues. See The “Numbers Game,” supra note 56; see also Jorge E. Guerra, *The Sarbanes-Oxley Act and the Evolution of Corporate Governance*, 74 THE CPA JOURNAL ONLINE (April 2004) available at www.nysscpa.org/cpajournal/2004/404/perspectives/nv5.htm.

76. Software maker Peregrine Systems Inc. famously booked as revenue non-binding sales of software licenses to resellers, made with the understanding that the resellers owed Peregrine nothing unless the software was sold to an end-user. Managers thereby created almost a half-billion dollars in bogus revenue over 11 quarters, which they needed to meet or exceed stock analysts’ expectations. See, SEC Accounting and Auditing Enforcement Release No. 1802 (June 16, 2003) and SEC Press Release 2004-141 (Oct. 6, 2004) (describing charges the SEC brought against Peregrine’s officers and the engagement partner for its outside auditor, Arthur Andersen LLP); and Lawrence A. Cunningham, *Sharing Accounting’s Burden: Business Lawyers in Enron’s Dark Shadow*, 57 BUS. LAW. 1421, 1426 & n.30 (2002).
lost about $56 billion in market capitalization between 1997 and 2002,\textsuperscript{77} and

suffered an immediate market-adjusted decline of almost 10 percent on average, measured on the basis of the stock’s three day price movement from the trading day before the restatement’s announcement to the trading day after the announcement.\textsuperscript{78}

SAS No. 99 tells auditors they “should ordinarily” presume there is a risk of material misstatement when fraud relates to revenue recognition.\textsuperscript{79} This has implications for whistleblower matters, for any information an employee discloses about intentional efforts to pad business revenues or shift them improperly to another accounting period carries a significant likelihood that it will be qualitatively material to an auditor, not for its size but for its reflection on management’s trustworthiness, or at least the adequacy of its internal controls at the operating level where the padding hit the books.

Other intentional, and perhaps small misstatements, may be devised by management for a host of reasons: to make it appear that the entity is complying fully with loan covenants; to mask changes in trends, such as changes in the rate of growth (or decline) in important lines of its business, in the percentage of goods sold that customers return, or in the amount or value of inventory on hand. Each of these tends could be significant to creditors, investors or other users of financial statements, although the salient amounts may correspond to a small percentage of the business’s gross revenue. A discovery that a member of senior management in a public company fraudulently overstated expenses for reimbursement almost inevitably will be immaterial quantitatively. Yet it requires an auditor to reevaluate the integrity of that individual and the impact an untrustworthy person in his or her position could have on the quality of the entity’s financial statements.\textsuperscript{80}


\textsuperscript{78} What Caused Enron? supra note 8, at 19.

\textsuperscript{79} SAS No. 99 at ¶41.

\textsuperscript{80} Id. ¶ 76.
The PCAOB is monitoring carefully how well its registered accounting firms are looking for fraud during audits.  

3. The SEC

The SEC approach to materiality incorporates the orthodox views of the accounting profession, but the Commission makes clear in its pronouncements that materiality is not an element of all transgressions of the securities laws it enforces. A second bedrock principle is that securities issuers must keep accurate records. The SEC’s views on these matters carry special significance because the Secretary of Labor’s Sarbanes-Oxley regulations permit the SEC to weigh in on securities issues by participating in whistleblower proceedings as an *amicus curiae*, although it has yet to do so.

i. SEC Staff Accounting Bulletin No. 99

Both Arthur Levitt, a former Chairman of the SEC, and the 1999 Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees established by the Securities Exchange Commission, the New York Stock Exchange, and the National Association of Securities Dealers had expressed concern that the concept of materiality was being misused to “mask inappropriate accounting treatment” in order to manage earnings and meet stock market analysts’ forecasts. The SEC issued its *Staff Accounting Bulletin* No. 99 – *Materiality*, to deal with that problem, to guide corporate managers as they apply materiality thresholds to financial reports filed with the Commission, and to assist accounting

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82. 29 C.F.R. § 1980.104(a) (copies of complaints are provided to the SEC), and 1980.108(b) (SEC may act as *amicus curiae*).

83. See the remarks on materiality by former SEC Chairman Arthur Levitt in “The Numbers Game,” *supra* note 55, and the 1999 Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees, at 18-19.

firms as they audit those financials. The SEC determined that no valid principle suggests that the misstatement or omission of an item that falls below a 5% threshold, or multiple small misstatements that net to less than a 5% threshold, become immaterial. (The 5% threshold itself assumed other particularly egregious qualitative problems were absent, such as self-dealing or misappropriation by the entity’s senior management).  

Bulletin No. 99 emphasized that accounting literature holds that only those who know all the facts are in a position to make materiality judgments, as well as FASB’s position that no general rule could capture all the considerations that enter into an experienced human judgment. It also pointed out that materiality is not the only standard used to judge the adequacy of a security issuer’s financial records. Accurate entries in books and records are required too.

ii. SEC Statutes and Rules Require Accurate Books

The SEC specifically recognizes in Bulletin No. 99 that “failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.” Section 13(b)(2) of the Securities Exchange Act contains two accounting provisions, the “books and records” provision of § 13(b)(2)(A) and “internal controls” provision of § 13(b)(2)(B), neither of which are limited by materiality thresholds. Section 13(b)(2)(A) requires issuers to make and keep books, records, and accounts that accurately and fairly reflect the transactions and dispositions of their assets. Section 13(b)(2)(B) obliges issuers to create internal accounting controls adequate to give “reasonable assurance” that their financial transactions are recorded accurately, fairly and in “reasonable detail,”

86. “The predominant view is that materiality judgments can properly be made only by those who have all the facts.” Bulletin No. 99, supra note 84, at paragraph accompanying fn. 7, relying on FASB Concepts Statement No. 2, at ¶ 131.
so they can prepare financial statements conforming to generally accepted accounting principles. The statute describes "reasonable assurance" and "reasonable detail" as the degree of assurance and the level of detail that would satisfy prudent officials in the conduct of their own affairs.

Added as part of the Foreign Corrupt Practices Act, these subsections "promote the reliability and completeness of financial information that issuers are required to file with the Commission or disseminate to investors pursuant to the Exchange Act." Congress adopted them after concluding that corporate books hid foreign bribery by American corporations. The duty to keep accurate books and records was not limited to bribery contexts, however, adding a potent weapon to the antifraud arsenal. They reach such matters as the back dating of options granted to corporate officers, as the former General Counsel and CFO for Apple, Inc. both learned. Counts accusing them of responsibility for inaccurate books and records and inadequate internal accounting controls figured prominently in the SEC's complaint against them for back dating options Apple's board granted in February and December 2001. The CFO settled by consenting to a permanent injunction against future violations of securities statutes and rules and paying more than $3.65 million dollars.

The SEC implements § 13(b)'s requirements with, among others, its rule 13b2-1, that says: "No person shall directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act." This rule is not aimed at insignificant technical infractions or inadvertent errors, but at deliberately false entries and management overrides or

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96. 17 C.F.R. § 240.13b2-1.
evasions of internal accounting controls. The federal courts have upheld the SEC’s authority to discipline corporate officers of issuers who violate SEC rule 13b2-1 without requiring proof of scienter (i.e., proof of an extreme departure from the standard of ordinary care that creates a danger of misleading investors), because no language in § 13(b) of the Securities Exchange Act the rule is based on requires scienter. The SEC consistently has taken the position that it can bring civil and administrative enforcement actions against individuals who cause an issuer to violate § 13(b)(2). The statute and rule reach beyond a security issuer’s officers and employees, to encompass third parties who cooperate in schemes to create false entries in an issuer’s books, records, or accounts.

The SEC takes enforcement action against issuers who keep inaccurate books and records when the errors are too small to be quantitatively material. An SEC proceeding against Duke Energy, an entity familiar from the district court decision on materiality discussed in Part II (B), supra, illustrates the point particularly well.


Duke Energy mounted no defense to the administrative cease-and-desist proceeding the SEC brought against it for violating § 13(b)(2). Traders in Duke Energy’s unit in Houston falsely recorded over $56 million in speculative trades in electricity and natural gas products with other energy companies from June 1997 through at least November 2002, by using accrual accounting for what generally accepted accounting principles required the trades to be recorded with mark-to-market accounting.\(^9\) Accrual accounting permitted some portions of gains or losses from valid hedge transactions to be deferred to later periods, but applicable mark-to-market accounting required all gains or losses from speculative trades to be recognized in the current accounting period. Duke Energy’s deficient internal controls allowed traders, who received year-end bonuses and other performance-based compensation tied to the profitability of their trades over the last year, to assign individual trades to the accrual and mark-to-market ledgers of its books, with no system to monitor which ledger traders placed them on, or trader’s decisions to shift trades between ledgers.\(^10\) The failure to time-stamp trading tickets helped traders exploit the system and shift trades based on whether a position produced a gain (which they placed on the mark-to-market ledger to recognize the entire gain currently) or a loss (which they assigned to the accrual ledger so part of the loss would be recognized after bonuses had been set).

The SEC specifically acknowledged in its cease and desist order that these “misclassifications did not have a material impact on Duke Energy’s financial statements,”\(^10\) but found that Duke Energy nonetheless had violated § 13(b)(2)(A) of the Securities Exchange Act by its failure to keep books, records, and accounts that accurately and fairly reflected the transactions and dispositions of its assets in reasonable detail. It also had violated § 13(b)(2)(B), which required it to maintain a system of internal accounting controls sufficient to provide reasonable assurances that: (1) transactions were executed in accordance with management’s general or specific authorizations; (2)

\(^10\) Id.
transactions were recorded in ways that permitted the preparation of financial statements that conformed to generally accepted accounting principles; and (3) it maintained accountability for its assets, by comparing recorded assets with the existing assets at reasonable intervals, and took appropriate action with respect to any differences.

   a. A Full Appreciation of Materiality in Public Accounting

    The FASB, AICPA literature and SEC Bulletin No. 99 provide rich resources for exploring the quantitative and qualitative aspects of materiality. The essential point is that materiality, as certified public accountants comprehend it, cannot be assessed simply by comparing the size of a questionable transaction or entry the whistleblower provides information about to the public company's gross revenue (as the district court did in In re Duke Energy Corp. Sec. Litigation)\(^{102}\) or to some other line item in the financial statements, such as its gross profit, pretax and net income, total assets, or shareholders' equity.

    Those simplistic comparisons turn a blind eye to the potential implications of the information a whistleblower disclosed, that may transcend the amount involved. For example, the value of inventory such as clothing in the fashion industry, or computer chips or other components that operate at certain speeds in computer manufacturing, may decline rapidly as tastes change or technology progresses. An employee who reports that a manager seems to have inflated the value of inventory may know the "what" (the inflation) but not the "why" (a desire to exaggerate inventory values just enough to maintain a specific working capital ratio, perhaps one a loan covenant requires). The incremental falsehood may not involve many dollars, but may betoken a lax attitude to the truth that would distress creditors and investors, leading them to distrust other entries on the financials. Avoiding Enron-like debacles by bringing questionable actions to light before they impair or destroy the enterprise is an important reason Congress enacted the whistleblower protections.

    Returning to a more concrete example, had any employee gone to

a manager or to the SEC to complain about any one of the four deficiencies in internal controls at Duke Energy’s trading unit (letting traders shift trades among ledgers, failing to monitor whether traders assigned a trade to a specific ledger when the trade was executed, failing to maintain time-stamped trading tickets, and failing to monitor traders’ moves of losing positions from the mark-to-market to the accrual ledgers) the employee would have provided information about violations of SEC Rule 13b2-1, violations that actually led to an SEC enforcement action. Yet the manipulated trades were quantitatively immaterial, individually and cumulatively, as the SEC recognized. The hypothetical whistleblowing employees would have been protected because he or she satisfied one of the Sarbanes-Oxley Act’s predicates—providing information about a violation of an SEC rule.

The next section develops more fully the reasons why a whistleblower need not prove the quantitative or qualitative materiality of the information disclosed to qualify for job protection under the Act.

b. To Lay Employees

An employee who claims to have suffered retaliation after disclosing information about what looked like corporate misconduct probably never had access to all the relevant facts. A determination of materiality is an onerous one for an independent auditor, who has the advantage of designing an audit based on the business risks associated with a particular client and its industry, the strength or weakness of the client’s internal controls, the quality of its accounting, and the characteristics of the specific accounts or balances involved. It is unlikely that a conscientious employee will be in any position to appreciate what is “material” to those who use financial statements—securities analysts, Wall Street investors, current or potential lenders, or the SEC. Congress never required the employee to guess about it, on peril of losing the statute’s protection.

Even when the employee reports an actual violation of law, the courts assess whether the employee believed in good faith an infraction occurred as they determine whether the disclosure was protected. The Seventh Circuit recently applied the whistleblower
A protection provision of 46 U.S.C. § 2114, a statute that uses a similar but not identical formulation to Sarbanes-Oxley’s description of protected acts: a seaman must have a good faith belief that he is reporting to the U.S. Coast Guard a violation of law. The court generally affirmed the relief granted to merchant marine officers terminated in retaliation for their complaints to the Coast Guard about an amendment to a huge casino vessel’s Certificate of Inspection. Low-level Coast Guard officers amended it after the vessel’s operator applied to employ ship’s engineers who held limited, rather than unlimited licenses. The officers believed (correctly, as the court of appeals found) the amendment violated the Coast Guard’s own safety regulations, but the key to their cause of action was the honesty, not the accuracy, of the officers’ beliefs.

The courts also protect whistleblowers who make good faith complaints that were not frivolous, but simply mistaken. The Senate Judiciary Committee specifically relied on this judicial interpretation when it incorporated the “reasonable belief” test into the Sarbanes-Oxley whistleblower protection provision. Another appellate court permitted an employee fired in retaliation for participating as a witness in a safety-related proceeding to make a whistleblower protection claim without requiring him to show that any federal safety standard actually had been violated.

Administrative law judges at the Department of Labor have embraced this approach, as a quartet of decisions illustrate. In the first, a CFO initially declined to approve the bank’s repurchase of

104. Id. at 449, n.25.
105. See Passaic Valley Sewerage Commrs. v. U.S. Dep’t of Labor, 992 F.2d 474, 479 (3rd Cir. 1993) dealing with a whistleblower protection claim brought under § 507 of the Clean Water Act, where the court said “[A]n employee’s non-frivolous complaint should not have to be guaranteed to withstand the scrutiny of in-house or external review in order to merit protection under § 507(a) for the obvious reason that such a standard would chill employee initiatives in bring to light perceived discrepancies in the workings of their agency.” Id.
106. See post text accompanying note 132.
shares from the CEO and one of the bank’s directors, sales which the CEO had authorized. The CFO’s disapproval led the board of directors to create a Stock Oversight Committee, due to concerns about insider trading and possible liability under SEC Rule 10b-5. Several months later the CEO again proposed to sell shares back to the bank. He offered them at a price that was about 20 times earnings, when shares historically traded closer to 15 times earnings. The CFO informed the board and the newly established Stock Oversight Committee of her belief that the price the CEO was offering to sell 45,000 shares of stock was higher than its fair market value, and unfavorable to other shareholders. After her objection the board’s additional research and analysis led it to offer the CEO a lower price. The bank argued that the CFO could not have reasonably believed the CEO’s offer to sell the shares violated any law or regulation enumerated in the Sarbanes-Oxley Act. The administrative law judge found that the CFO had a reasonable basis to believe the prices the CEO offered were inflated, and the board’s creation of the Stock Oversight Committee and the additional investigation conducted before the purchase ultimately took place was further evidence of the reasonableness of the CFO’s belief that the proposed sale had the potential to violate the predicate SEC statutes. Both her reports qualified as protected activities, without the need for proof that the terms the CEO had offered actually violated any predicate statute or rule.\textsuperscript{108}

In a second case, the complainant claimed he had been told to delay his approvals of receiving memos that authorized Intel’s accounts payable department to pay invoices for products or services his unit had obtained.\textsuperscript{109} The delay, he said, was meant to reduce current expenses and thereby help Intel meet Wall Street earnings expectations.\textsuperscript{110} This was wrong, because Intel’s accrual accounting booked expenses when an invoice was received, not when it was paid. Someone in the complainant’s position at a computer chip factory would not have enough control over invoice payments to dent Intel’s earnings targets, even if the delay instruction the complainant claimed were implemented in all of Intel’s chip fabrication plants.

\textsuperscript{110} Id. at 15 (ALJ Mar. 4, 2004).
Intel nonetheless took the allegation seriously enough to investigate it thoroughly (partially at the behest of the SEC). The Department’s Administrative Review Board accepted that the complainant sincerely believed there was an improper delay in the payment of invoices, so disclosing his concern within Intel and to the SEC were protected activities.\footnote{Halloum v. Intel Corp., ARB No. 04-068, 2003-SOX-7, slip op. at 6 (ARB Jan. 31, 2006).}

The third matter involved an in-house lawyer’s claim to employment protection. He said he was terminated after he objected to the way $60 million in earnings were characterized in financial statements prepared as the U.K.-chartered television production company he worked for in Southern California merged with another entertainment production entity.\footnote{Gallagher v. Granada Entm’t USA, 2004-SOX-00074 (Order Granting Summary Dismissal) (ALJ Apr. 1, 2005).} The resulting entity that employed him was required to make SEC filings, which subjected it to his Sarbanes-Oxley whistleblower claims. He contended the accounting misclassification was done to offset operating costs in a U.K. production division, and also that his superiors misrepresented to outside auditors that a U.K. lawyer was the head of U.S. Business and Legal Affairs rather than him, in an effort to keep his objections from being aired.\footnote{Id. at 8.} These assertions qualified for protection, whether or not the substantive accounting treatment for the operating costs was correct. Ultimately, his case failed for other reasons.

Finally, an employee’s communication to management of an objectively reasonable belief that officials had altered records and falsified expense reports, inflated business expenses and failed to substantiate expenses to deceive external auditors was sufficiently related to violation of SEC rules to qualify as a protected activity, without regard to whether the amounts involved would be material to an auditor.\footnote{Caldwell v. Airgate Int’l Corp., 2007-SOX-26, slip op. at 7 (ALJ May 1, 2007) (denying a motion to dismiss the complaint).}

There is no reason to presume that employees who complain within a corporation, or to a federal agency or to Congress, will appreciate the full implication(s) of questionable acts they observe and report. Employees who suffer job retaliation because they were
concerned enough to report what looked like misconduct or the violation of an SEC rule need not prove the transgression would be material on the employer’s financial statements. As the next section demonstrates, that is not an essential element of their claim.

III. CONTRASTING THE ELEMENTS OF SECURITIES FRAUD AND SOX EMPLOYEE PROTECTION

A side-by-side contrasting of the essential elements of a claim for securities fraud and for employment protection under § 806 of the SOX Act, 18 U.S.C. § 1514A, may be useful. It becomes obvious immediately that they have little in common.

The elements of a securities fraud claim under Sec. 10(b) of Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) are:

(1) to use or employ any manipulative or deceptive device or contrivance;
(2) scienter, i.e. wrongful state of mind;
(3) a connection with the purchase or sale of a security;
(4) reliance, often referred to in fraud-on-the-market cases as “transaction causation;”
(5) economic loss; and
(6) loss causation, i.e., a causal connection between the

The elements of a whistleblower liability under SOX are:

(1) to engage in a protected activity or conduct as a covered employee in a covered employer;
(2) the employer knew of the protected activity;
(3) the employee suffered an unfavorable personnel action; and
(4) the protected activity contributed to the unfavorable employment action.
Note: The employer avoids liability by proving with clear and convincing evidence that it would have taken the same unfavorable personnel action in the absence of the protected activity. 29 C.F.R. § 1980.109(a).


Securities fraud plaintiffs also face daunting pleading requirements in district court imposed by the Private Securities Litigation Reform Act of 1995,115 including the duty to be quite specific about what misstatements were made, and to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”116 Just how specific their allegations must be to raise the necessary “strong inference” of scienter is in flux. _See, e.g.,_ the Seventh Circuit’s decision in _Makor Issues & Rights, Ltd. v. Tellabs, Inc._117 that reversed a district court’s determination that materiality had been pled inadequately.

It may be impossible for an employee to frame the specific, detailed allegations that would be required to withstand a motion to dismiss if the claim were presented as one for securities fraud in U.S. district court, particularly with regard to materiality and scienter. Fortunately for the employee, Congress never required whistleblowers to do so.

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IV. INSIGHTS FROM LEGISLATIVE HISTORY AND RULE MAKING

A. The Legislative History

To protect corporate whistleblowers, Congress incorporated into Title VIII of the Sarbanes-Oxley Act work already done on Senate bill S. 2010, entitled the Corporate and Criminal Fraud Accountability Act of 2002. The legislative history of the Sarbanes-Oxley Act’s employee protection provisions includes the comments Senator Leahy made on the Senate floor on July 26, 2002, the day after the Act was passed, but before the President signed it. He gave a section-by-section analysis of Title VIII that includes § 806 (now 18 U.S.C. § 1514A) on whistleblowing, and reminded the Senate that the terms enacted in Title VIII “track almost exactly the provisions of S. 2010.”

The Senate Judiciary Committee Report for S. 2010 is somewhat more detailed than Sen. Leahy’s floor remarks; for example, the Report included minority views. The Report recognized that “securities frauds are inherently complex, and the law should not reward the perpetrator of a fraud.” On that basis, the bill included a group of statutory changes, such as extending the statute of limitations for securities fraud to five years after a violation occurred or two years after the violation is discovered, overruling the Supreme Court’s decision in Lampf v. Gilbertson. The criminal penalties it imposed for the willful failure to preserve audit papers of companies that issue securities addressed a flashpoint for outrage in the Enron fiasco.

The Senate Report recognized that in complex frauds, employees are often insiders who know firsthand “who knew what, and

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119. Id. at S7420.
120. Id. at S7418.
122. Id. at 8.
124. See supra text accompanying notes 16-17.
when,"125 and analogized the corporate whistleblower protections created by the Federal Whistleblower Protection Act which protects federal employees "who act in the public interest by reporting wrongdoing."126 Congress never intended to strip corporate employees of protection if they erred by reporting as violations of statutes or rules what turned out to be benign actions or comparatively small defalcations. Not every whistleblower will be a Sherron Watkins of Enron, a certified public accountant127 who appreciated that a scheme was afoot that could (and did) bring the company down. Congress therefore chose to incorporate a "reasonable belief" standard into the statutory text, which it drew from judicial interpretations of other whistleblower statutes. See, 18 U.S.C. § 1514A(a)(1).128

The Senate Report specifically approved the Third Circuit's decision in Passaic Valley Sewerage Commissioners v. Department of Labor, a whistleblower protection matter that arose under the Clean Water Act, which held that the employee need not prove an underlying statutory violation to enjoy whistleblower protection.129 The information the employee provides need only relate to a predicate fraud or a violation of an SEC rule, it need not equate to it, in the sense of making out a fully actionable case of mail, wire, bank

125. Senate Report, supra note 4, at 10.
126. Id. at 19.
128. No covered employer may discriminate against an employee for lawful acts done "to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of §§ 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders. . ." 18 U.S.C. § 1514A(a)(1) (emphasis added).
129. Passaic Valley Sewerage Comm't v. U.S. Dep't of Labor, 992 F.2d 474, 470 (3rd Cir. 1993). See supra note 105 (relevant passage from that decision quoted).
or securities fraud. The Senate Report and Senator Leahy’s remarks on July 26, 2002, gave two touchstones to identify a protected activity: (1) did the employer investigate the claim of wrongdoing, or take other action in response to the employee’s disclosure, and (2) would the information the employee provided be admissible in a trial for any of the whistleblower provision’s predicate offenses. Senator Leahy said:

Certainly, although not exclusively, any type of corporate or agency action taken based on the [employee’s] information, or the information constituting admissible evidence at any later proceeding would be strong indicia that it could support a reasonable belief. The threshold is intended to include all good faith and reasonable reporting of fraud, and there should be no presumption that reporting is otherwise, absent specific evidence.130

The text of the Sarbanes-Oxley whistleblower protection provision in 18 U.S.C. § 1514A nowhere restricts employee protection to disclosures of actionable fraud under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the SEC regulations. For more than thirty years only purchasers and sellers of securities have been able to seek redress in federal courts. In *Blue Chip Stamps v. Manor Drug Stores*,131 the Supreme Court rejected the argument that investors dissuaded from buying a security by material misrepresentations should be able to obtain relief under § 10(b) of the Securities Exchange Act of 1934. The plaintiff claimed the issuer purposefully overstated the investment risk to keep the number of purchasers small. Having failed to buy the security, the Court ruled the plaintiff had no cause of action.132 If a whistleblowing employee were required to prove every element of a securities fraud cause of action, the employee would need to have purchased or sold a security in the employer to prevail (the third

130. See 148 Cong. Rec. at S7420, col. 3 (daily ed. July 26, 2002); the first sentence of this quoted language also appears in the Senate Report, supra note 4, at 19.
132. *Id.* at 752.
element of a § 10(b) claim in the chart above). No employer appears to have argued that the purchase or sale of a security the employer issued is an element of an employee’s Sarbanes-Oxley whistleblower protection claim. There is no more reason to introduce a materiality requirement into Sarbanes-Oxley employee protection proceedings than to import a Blue Chip Stamps-type purchase requirement. Neither have a basis in the statute’s text or the Secretary’s regulations.

Economic loss from the purchase or sale of a security also is an element of a § 10(b) claim (the fifth and sixth elements of a § 10(b) claim in the chart above). But that is not the type of injury a Sarbanes-Oxley whistleblower must prove. The Secretary’s regulations forbid employers to “discharge, demote, suspend, threaten, harass or in any other manner discriminate against any employee” who has engaged in a protected activity. Harassment or other forbidden discrimination (such as reduction in duties or transfer or reassignment to less meaningful work) may not have the economic bite of a termination or suspension, but may suffice to dissuade other employees from making the disclosures Congress wants to encourage. Cf., the decision of the U.S. Supreme Court in Burlington Northern & Santa Fe Railway Co. v. White, that found actionable retaliation when the employer assigned a worker who complained of Title VII sex discrimination to less desirable, physically onerous duties. Lost wages, benefits and even consequential damages for emotional distress from harassment are recoverable damages in Sarbanes-Oxley Act whistleblower proceedings. Loss from an investment the employee may have

133. Id.
134. 29 C.F.R. § 1980.102(a), which closely tracks the provisions of 18 U.S.C. § 1514(a).
made in some security the employer issued is not a required element of a whistleblower’s claim.

In essence the only materiality involved in a Sarbanes-Oxley whistleblower matter is that which inheres in relevance as defined in Federal Rule of Evidence 401, quoted in Part II (A) above. If the information the employee reported led the employer to investigate or to take action in response, or would be relevant evidence at a hypothetical or actual trial for:

- mail fraud, wire fraud, bank fraud, or securities fraud,
- the violation of any rule or regulation of the SEC, or
- the violation of any provision of federal law relating to fraud against shareholders

The employee’s disclosure of information is protected. See, Collins v. Beazer Homes USA, Inc., where the district court found protected activity when the employer took the whistleblower’s allegations seriously enough to investigate the allegations, relying on the test stated in the legislative history. The information does not have to be sufficient to make out an independent cause of action under one of those predicate statutes or SEC regulations to be protected activity.

1. The Secretary of Labor’s Sarbanes-Oxley Regulations

The Secretary of Labor declined the suggestion offered during the course of rulemaking to incorporate a materiality requirement into the Sarbanes-Oxley whistleblower protection regulations. The interim regulations solicited public comments that were considered when the Secretary issued the final rule on August 24, 2004. The Human Resource Policy Association suggested that employment protections should extend “only [to] disclosures of fraud that harm shareholders or that relate to securities law.” It feared that the

137. FED. R. EVID. 401.
138. See the list of statutes at note 27, supra.
141. 69 Fed. Reg. 52103 et seq.
Secretary’s interim regulations could lead to Sarbanes-Oxley whistleblower claims arising out of “ordinary business and employment disputes” the Act was not meant to address, so it suggested that an employee’s disclosure not qualify for Sarbanes-Oxley whistleblower protection unless the information reported “affect as much as 3% of a company’s revenue.”143 Rejecting that sort of amendment to 29 C.F.R. §1980.102 (on Obligations and Prohibited Acts), the Secretary replied:

[T]he purpose of these regulations is to provide procedural rules for the handling of whistleblower complaints and not to interpret the statute. Furthermore, determinations as to whether employee disclosures concerning alleged corporate fraud are protected under Sarbanes-Oxley will depend on the specific facts of each case. It is not appropriate therefore for these regulations to specify a percentage or formula for use in defining protected activity (emphasis added).144

This Delphic Secretarial comment can be read narrowly, as deferring any decision about whether the employee’s disclosure was significant enough to be protected to case-by-case adjudication. It also can be read to flatly reject the notion that the information the employee disclosed must involve some percentage of gross revenue (or other metric found in financial statements) to qualify as a protected activity. The latter is the better reading, because it comports with the absence of any test for significance in the statutory text, and with the decisions of the courts of appeals the Senate Judiciary Committee expressly approved in the legislative history.

143. Id.
144. Id.
V. ALJ DECISIONS CONSIDERING MATERIALITY

A. Decisions dealing with quantitative and qualitative materiality

The handful of administrative law judge decisions that discuss materiality go both ways on the complainant’s duty to show that the information is “material.” The better reasoned ones find materiality need not be proven. The early Sarbanes-Oxley decision in Morefield v. Excelon Services, Inc.\(^{145}\) is consistent with the choice the Secretary made four months later in the final Sarbanes-Oxley rule not to set quantitative materiality thresholds for protected activities.\(^{146}\) A fraud too small to be quantitatively “material” to an auditor may involve a king’s ransom in an ordinary wage earner’s eyes (such as the $56 million involved in the cease-and-desist proceeding the SEC brought against Duke Energy for the deficiencies at its energy trading unit).\(^{147}\) The alleged manipulative treatment in Morefield of vacant leases, intentionally improper adjustments to balance sheets, biased financial forecasts incorporated in one fiscal year and the improper treatment of a business unit’s liabilities in the next involved $2 million. The challenged entries never found their way into the parent’s external quarterly or annual financial statements, and represented only about .0001% of the parent corporation’s annual revenue of $15 billion.\(^{148}\) Nonetheless the information a vice-president for finance at the subsidiary provided qualified as protected disclosures.\(^{149}\)

The administrative law judge recognized that the Sarbanes-Oxley whistleblower provisions are designed to be “prophylactic, not punitive.”\(^{150}\) The Act “places no minimum dollar value on the protected activity it covers” and “[t]he mere existence of alleged manipulation, if contrary to regulatory standard, might not be criminal in nature, but it very well might reveal flaws in the internal


\(^{146}\) Duke Energy, 282 F. Supp. 2d at 158.

\(^{147}\) Morefield, 2004-SOX-2, 8.

\(^{148}\) Id. at 8.

\(^{149}\) Id.

\(^{150}\) Id. at 16.
controls that could implicate whistleblower coverage for seemingly paltry sums.”

In a second case the complainant, an experienced executive who held an MBA, claimed he was fired because he told his supervisor that the company’s practice of computing the ageing of its inventory in dollars rather than in product units was misleading. He acknowledged that the company’s use of dollar figures for inventory conformed to generally accepted accounting principles. The judge dismissed the claim, but in the course of the decision also rejected the company’s contention that the complainant’s objection to a $21.6 million software write-off that affected the inventory calculation could not be a protected activity, because it had less than a 1% effect on the “[days of inventory] figure” for the entire year, rendering it immaterial.

This analysis contrast starkly with the decision in Wengender v. Robert Half International, Inc., which granted summary judgment to an employer, in part because the judge believed that materiality is “an integral element of a [Sarbanes-Oxley] claim.”

A salesperson for a firm that placed skilled employees in temporary jobs complained he was constructively discharged for reporting what he believed were improper commission payments to employees who had not earned them. The administrative law judge found that the record failed to show that the complainant had engaged in a protected activity for three reasons:

- First, the complainant made inconsistent allegations, contending for the first time in his objections to OSHA’s investigative findings that the commission reassignment violated federal securities laws or regulations. Earlier he claimed the reassignment violated general accepted accounting principles (GAAP) and made general allegations of fraud, but the judge held that the whistleblower protection provision “does not apply to generic allegations of accounting

151. Id.
154. Id.
violations, violations of GAAP, or general allegations of fraud." The complainant’s supervisor reassigned the credits as an incentive to a new employee, not to defraud shareholders.

- Next, the judge found the evidence did not support a claim that the complainant actually believed when he voiced his objections internally or when he file his complaint at the Department of Labor that the reassignment violated laws against shareholder fraud. He told his supervisor that he did not oppose reassigning credits, he wanted his own efforts that generated credits in that account to be rewarded.

- Finally, on materiality, the uncontested facts demonstrated that the $12,500 in reassigned credits was so small in comparison to the employer’s total revenue, net revenue, total assets and shareholder’s equity that it would have been lost in rounding on the Form 10-K annual report the employer filed with the SEC. It therefore did not rise to the level of materiality the Sarbanes-Oxley Act requires since “it would not be included in any disclosures to [the employer’s] shareholders.

Even if the holding that materiality must be demonstrated before an employee qualifies for protection were correct, it repeats the district court’s error in In re Duke Energy Corp. Securities

155. The comment relies on Marshall v. Northrop Grumman Synoptics, 2005-SOX-8, slip op. at 5-6 (ALJ June 22, 2005), a summary judgment entered for an employer when the employee alleged senior managers willfully misclassified hours of labor, depreciation and capital expenses in violation of generally accepted accounting principles. That administrative law judge found record evidence only of possible violations of the company’s internal accounting policies and ethics standards, not of a fraud against shareholders. It is doubtful that this holding survived the ARB’s decision in Klopfenstein v. PCC Flow Techs. Holdings, Inc., ARB No. 04-149, ALJ No. 2004-SOX-11 slip op. at 17 & n.20 (ARB May 31, 2006). Failing to follow a public company’s internal accounting policies likely also violates its internal controls and procedures, and thereby contravenes SEC Rules published at 17 C.F.R. § 240.13a-15(a) and § 240.15d-15(a).


157. Wengender, supra note 153, at 17. It is unclear whether the judge believed the employee was attempting to ground his complaint on the duty § 302 of the Sarbanes-Oxley Act imposes on the CEO and CFO to file accurate reports with the SEC, or held that all employee complaints about accounting matters implicate § 302. See supra note 12.
Litigation. Governing accounting principles preclude measuring materiality through facile quantitative comparisons of the amount involved in the complaint to line items on SEC filings. (The employee seems not to have raised this argument, however). More importantly, the proposition that materiality is an element of a employment protection claim lacks any basis in the statute or the Secretary of Labor’s regulations; Part III of this article already demonstrated this by contrasting the elements of a securities fraud cause of action and a whistleblower claim.

Materiality was discussed, but not pivotal, in a fourth administrative law judge decision that ultimately turned on the employer’s proof that it had a legitimate intervening reason to terminate the complainant, an electrical site engineer at an internet server farm. The employee claimed he was fired because he told the CEO and other managers that a report the company sent to customers explaining the reasons for a power outage at its Chicago Data Center (one of seventeen it operated) was false in several respects. That explanation was not distributed to shareholders, who received information about credits given to customers for the service interruption. An investment advisory service (Tier 1 Research) concluded there had been “no (material) customer fallout” from the outage, so the company’s managers still expected to make $250 million by the end of the year. The administrative law judge assumed for the sake of argument that the objection the engineer expressed within the company came within § 302 of the Sarbanes-Oxley Act, although he doubted the engineer had shown any factual inaccuracies in the report to customers that were “actually material to the representation of Equinix’s financial condition.”

158. 282 F. Supp. 2d 158 (S.D.N.Y. 2003); see supra notes 47, 102.
159. Part III, supra.
161. The business also was described as a “mutual network data center.”
164. Id. at 7.
166. Giurovici, at 14.
The context of the remark leads to the inference that the judge had quantitative materiality in mind.

The administrative law judge found clear and convincing evidence that the employer legitimately terminated the complainant for his progressively deteriorating work attitude, something well documented in counseling memoranda and his performance appraisals.\(^\text{167}\) Those deficiencies continued after he objected to the employer’s published explanation for the electrical outage.\(^\text{168}\) The materiality analysis, which considered whether the complainant engaged in protected activity by asserting that management had engaged in shareholder fraud, was not crucial to the outcome of the decision.

The analyses in the *Morefield* and *Richards* decisions that focus on the absence of any threshold to qualify for protection in the statute’s text make them the more persuasive authorities. The Secretary’s rejection of any formula to define protected activity as she adopted the final rules on Sarbanes-Oxley whistleblower claims buttresses this conclusion.

i. Decisions rejecting claims unrelated to the SOX predicate statutes

Violations of statutes absent from the list of predicate offenses should be treated as legally immaterial in a Sarbanes-Oxley whistleblower protection proceeding. They are not “of consequence” to the employee’s claim for employment protection, and immaterial in the way relevance is defined in Federal Rule of Evidence 401. This approach has the advantage of obviating speculation about whether, if a non-predicate statute has been violated, the impact of the violation may be material under SEC Rule 10b-5 or some accounting definition of materiality. Violations of non-predicate statutes have not always been treated this way, however. This section will survey some of the approaches administrative law judges have taken to claims for protection that were not based on violations of the Sarbanes-Oxley predicate statutes.

Sarbanes-Oxley employment protections claims have been rejected where the employee could not identify in the course of the

\(^{167}\) *Id.* at 16.

\(^{168}\) *Id.*
protected activity, for it implicated the other frauds the statute enumerates (bank fraud, mail fraud and wire fraud). Providing information about the violation of “any rule or regulation of the Securities and Exchange Commission” qualifies for protection too, and those rules may proscribe conduct without regard to the actor’s fraudulent intent. For example, false entries in corporate records can violate § 13 of the Securities Exchange Act and SEC Rule 13b2-1.

2. Ineffectual Management

Complaints to managers that poor project decisions were being made, and that the business will fail to achieve earnings because managers were failing to make capital investments, do not qualify as protected activities. Inept management is not fraud.

3. Violation of Environmental Laws


171. See Klopfenstein v. PCC Flow Techs. Holdings, Inc., ARB No. 04-149, ALJ No. 2004-SOX-11 slip op. at 17 & n.20 (ARB May 31, 2006) that remanded the matter for the administrative law judge to determine whether the complainant engaged in protected activity by informing senior managers that the company’s internal controls for the accounting treatment of inventory-in-transit could affect the accuracy of its financial statements. Poor internal controls, or implementing facially adequate controls poorly, could violate SEC rule “13a-15a,” an apparent reference to 17 C.F.R. § 240.13a-15(a). But see Bishop v. PCS Admin. (USA), Inc., 2006 WL 1460032, at *9 (N.D. Ill. May 23, 2006) where a district court held that the phrase “relating to fraud against shareholders” in the whistleblower protection provision of the Sarbanes-Oxley Act should be read as modifying each item in the series, including “rule or regulation of the Securities and Exchange Commission.”

172. 17 C.F.R. § 240.13b2-1; supra note 96, quoted at the text accompanying.

173. Id.

Summary judgment was entered for the employer where the claim grew out of an allegation that the employer violated the SEC rule published at 17 C.F.R. § 229.103 (S.E.C. Regulation S-K, item 103) that requires public companies to disclose administrative proceedings initiated against them for discharging materials into the environment, or for the primary purpose of protecting the environment. 175 The complainant lacked any objectively reasonable basis to believe that such proceedings had been filed (and none had been), so there was nothing for the employer to disclose. 176

A complaint to the employer about poor air quality in office space related neither to fraud nor to any of the Sarbanes-Oxley predicate statutes or rules, and was dismissed. 177

4. Violation of Tax Laws

A complainant alleged he suffered job discrimination after he complained that the employer had mischaracterized some workers as independent contractors, to dodge liability for the employer’s share of social employment taxes, premiums for workers’ compensation insurance, and to evade federal wage and hour and other labor laws. He contended these violations would concern a reasonable shareholder, an oblique assertion that they were material in the sense used in securities law. 178 The administrative law judge found no protected activity, because none of these potential violations related to any Sarbanes-Oxley predicate statutes. 179

5. Violation of Wage and Hour Laws

Administrative law judges have found that employees who complain that the employer violated federal wage and hour laws obtain no Sarbanes-Oxley whistleblower protection. The alleged

178. Id.
violation of the federal Fair Labor Standards Act from errors in the complainant’s weekly paychecks implicated no shareholder fraud.\textsuperscript{180} This decision was sound, for wage and hour violations have nothing to do with the predicate statutes. The judge went on to point out that the complainant had not shown that the employer made systematic wage underpayments to other employees that would affect the accuracy of the company’s financial statements, which in turn could defraud investors (an indirect reference to the concept of quantitative materiality).\textsuperscript{181} The judge’s observation, while no doubt correct, raised a materiality issue that could be avoided once it was determined that the wage dispute bore no relation to the Act’s predicate statutes.

6. Violation of Antidiscrimination Laws

Telling senior managers about potential racial discrimination claims fails to qualify for Sarbanes-Oxley whistleblower protection. A human resources employee complained he was fired for his threat to take to the EEOC, the Department of Labor and other agencies information he had collected about corporate practices he believed reflected race discrimination. His claim was dismissed on the merits for lack of a protected activity, and because the employer proved the termination was a legitimate response to his insubordination.\textsuperscript{182} Employees had filed no class action suit, so there was nothing for the company to disclose in its financial information.\textsuperscript{183} Moreover, when Congress identified the predicate statutes for Sarbanes-Oxley whistleblower claims, Title VII of the Civil Rights Act of 1964 was not among them; Title VII, after all, has its own anti-retaliation provision.\textsuperscript{184} The ALJ also found the complainant had no reasonable

\textsuperscript{180} Harvey v. Safeway Inc., 2004-SOX-21 (ALJ Feb. 11, 2005); see also Shelton v. Time Warner Cable, 2006-SOX-76, slip op. at 7-8 (ALJ Aug. 31, 2006) finding that information about possible violations of the Fair Labor Standards Act or ERISA did not confer protection on an employee when there was no inference the violations worked as frauds on shareholders.


\textsuperscript{182} Id.

\textsuperscript{183} Id.

\textsuperscript{184} The anti-retaliation provision makes it “an unlawful employment practice for an employer to discriminate against any of his employees...because [the
whistleblower claims, Title VII of the Civil Rights Act of 1964 was not among them; Title VII, after all, has its own anti-retaliation provision. The ALJ also found the complainant had no reasonable basis to believe that he was entitled to withhold information he had gathered from minority employees in field offices about how they thought the company treated them. Collecting that sort of information was one of the complainant’s duties. Because the employee lacked any basis to withhold the specific information he had learned in his diversity investigations, the employer was entitled to terminate him for being insubordinate.

The ALJ decision in *Harvey v. Home Depot Inc.*, touches on materiality, but the claim was dismissed on procedural grounds—the failure to have filed it within the 90-day period Congress gave to Sarbanes-Oxley complainants. The ALJ found that the complaints the employee filed with Home Depot within 90 days of his termination raised issues remediable, if at all, under Title VII of the Civil Rights Act. Race discrimination, which certainly is illegal, violates none of the Act’s predicate statutes, including the broad prohibition on violating “any provision of federal law relating to fraud against shareholders,” because race discrimination does not defraud shareholders. Ultimately the Administrative Review Board affirmed the dismissal. The Board has held that grievances communicated to the employer about personnel actions and practices the complainant regarded as racially discriminatory, objections to executive decisions and corporate expenditures the complainant regards as racially discriminatory, objections to executive decisions and corporate expenditures the complainant

184. The anti-retaliation provision makes it “an unlawful employment practice for an employer to discriminate against any of his employees...because [the employee] has opposed any practice made an unlawful employment practice by this subchapter, or because [the employee] has made a charge, testified, assisted, or participated in any manner in an investigation, proceeding, or hearing under this subchapter.” 42 U.S.C. § 2000e-3(a).
186. *Id.*
187. *Id.*
believed were inappropriate, and alleged violations of the federal Fair Labor Standards Act or Family Medical Leave Act were not protected activities under the Sarbanes-Oxley Act. What the employee discloses “must be directly related to the listed categories of fraud or securities violations” to be protected. The abstract possibility that a challenged practice might adversely affect the corporation’s financial condition, and this effect might be intentionally withheld from investors, is not enough.

Broadly read, racial discrimination by a company that claims to operate in a non-discriminatory fashion might seem to violate § 302 of the Sarbanes-Oxley Act itself, codified at 15 U.S.C. § 7241. That provision instructed the SEC to adopt a rule requiring corporate officers of a publicly traded company to certify that the company’s financial disclosures are accurate, contain no untrue statements of material fact, and fairly present in all material respects the financial condition and results of operations. The SEC rules implementing this portion of the Act became effective on August 14, 2003, although the date for smaller public companies to report on how they are complying with these duties has been extended.

192. *Id.* ARB slip op. at 14-15.
193. *Id.*
194. The CEO and CFO of each issuer of securities are required to prepare a statement to accompany the annual report to certify that “this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report” and that based on their knowledge, “the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report.” *See* the certifications required for a public company to comply with S.E.C. Rule 13a-14(a) (17 CFR § 240.13a-14(a)) or Rule 15d-14(a) (17 CFR § 240.15d-14(a)). The officers’ certifications must be in the exact language of the form prescribed at 17 C.F.R. § 229.601(b)(31) (the language quoted in this footnote comes from paragraphs 2 and 3 of that form).
If individual instances of invidious discrimination occurred, they did not render the corporation’s report of its financial condition inaccurate because they would not reach a quantitative materiality threshold in the auditing sense.\textsuperscript{197} Materiality becomes a matter in issue under that approach because § 302 of the Act\textsuperscript{198} specifically focuses on untrue statements of \textit{material fact} in the entity’s financial statements. At bottom, however, the untimely whistleblower claim came within none of the Act’s predicate statutes because the employee focused his complaints to the company on substantive discrimination claims, or alleged violations of the Fair Labor Standards Act or Family Medical Leave Act, not on a failure to disclose to the investing public allegations of discrimination that had never ripened into a lawsuit.

VI. THE ADMINISTRATIVE REVIEW BOARD

The Administrative Review Board reviews ALJ decisions in Sarbanes-Oxley matters on the Secretary of Labor’s behalf.\textsuperscript{199} Two principles have become established. The employee seeking protection must have communicated some information—to the company or to an agent of the federal government—that contributed to an adverse employment action; and the information given must relate to one of the Sarbanes-Oxley Act’s predicate offenses. Only one case implicating the concept of materiality has made its way to the Board, but no firm rule on materiality has been made.

\begin{footnotesize}
and the auditor attestation requirement in Item 308(b) of SEC Regulations S–K and S–B until their SEC filings are due for their fiscal years ending on or after Dec. 15, 2007. 71 Fed. Reg. 76,580 (Dec. 21, 2006). The SEC has not exempted smaller companies from the substantive duty to maintain effective internal control over their financial reporting, or to design and maintain disclosure controls and procedures.

\textsuperscript{197} Harvey, 2004-SOX-00020, slip op. at 15 (ALJ May 28, 2004). “\textit{[I]ndividual, rather than systemic, discrimination does not reach . . . [a] materiality threshold in terms of a corporation’s financial condition.}” Id. at 15.

\textsuperscript{198} Codified at 15 U.S.C. § 7241.

\end{footnotesize}
A. The Need to Communicate Information

The Administrative Review Board previously held that a plant manager who claimed he did not follow a directive to write inventory values down failed to prove that he “provided information” about something he reasonably believed violated one of the SOX predicate statutes, and so had not engaged in protected activity. The inventory (solid dishwashing detergent manufactured at the plant) was carried on the books as “good bulk” inventory when actually about 20% of it had been discarded because it was discolored and defective. He believed the write-down would make it appear that actual inventory on hand was being destroyed as defective, when the problem was the inventory just didn’t exist. He thought that mischaracterizing a write-down that he agreed needed to be made would be a type of cheating. But the whistleblower protection provision of Sarbanes-Oxley Act does not protect thoughts. The Board found that failing to take the write-down, by itself, communicated no concern to the company. Only telling a more senior manager (or perhaps an outside entity like the SEC) of his concern that the accounting change may work a potential fraud could qualify as whistleblowing.

Merely inquiring whether management has taken steps to comply with an accounting directive from the SEC was not a protected activity. The directive was SEC Staff Accounting Bulletin 101, which became effective in 2001, addressing the sensitive issue of

200. Henrich, ARB 05-030, 2004-SOX-51 (ARB June 29, 2006); see also Getman, ARB No. 04-059, ALJ No. 2003-SOX-8, slip op. at 9-10 (ARB July 29, 2005) (a stock analyst’s action in refusing to sign her name to a “strong buy” recommendation did not “provide information” to a person with supervisory authority about a violation of a predicate statute).
202. Id. at 4.
203. Id.
204. Id. at 11.
205. Id. at 14-15.
206. Id.
revenue recognition.\textsuperscript{208} It describes how public companies should recognize sales revenue before merchandise is delivered to customers.\textsuperscript{209} The employee never complained to management about how the company applied the directive in corporate financial statements for 2001, 2002 or the first three quarters of 2003.\textsuperscript{210}

\section*{B. The need to relate the information to a predicate statute or rule}

The Board requires complainants to relate the misconduct they report to the list of predicate offenses to show they have engaged in protected activity.\textsuperscript{211} A medical transcriber was unsuccessful in her \textit{pro se} complaint that underpaying her, and then firing her when she complained about it, gave her whistleblower protection.\textsuperscript{212} She sent three e-mails to a regional manager complaining that local managers improperly reduced the line count of her transcriptions to diminish her pay.\textsuperscript{213} The regional manager cancelled her contract after the third e-mail, prompting her SOX complaint claiming retaliation.\textsuperscript{214} The administrative law judge granted the employer’s summary judgment motion for her failure to show any protected activity.\textsuperscript{215} The Board affirmed because the transcriber never could explain how her e-mails “provided information about conduct she reasonably believed constituted a violation of the federal fraud statutes, or an SEC rule or regulation, or any other federal law relating to shareholder fraud.”\textsuperscript{216}

\begin{thebibliography}{9}
\bibitem{208} Id. at 5.
\bibitem{209} Id.
\bibitem{210} Id. at 14.
\bibitem{211} Id. (the first element of a whistleblower claim in the chart found in Part III, supra).
\bibitem{213} Id.
\bibitem{214} Id. at 2-3.
\bibitem{215} Id. at 3.
\bibitem{216} Reddy., ARB No. 04-123, ALJ No. 2004-SOX-35, slip op. at 89 (ARB Sept. 30, 2005); see also \textit{Trodden}, 2004-SOX-64 (ALJ Mar. 29, 2005), where the employer was a transportation services business, an industry in which companies differentiate themselves through their percentages of on-time deliveries. The
The Board also held that an employee may be entitled to protection for bringing to management’s attention inadequacies in the business’s internal controls over financial reporting. Securities issuers are required by § 13(b)(2)(B) of the Securities Exchange Act, § 404 of the Sarbanes Oxley Act, and the implementing rules of the SEC to maintain effective internal control over financial reporting. These are the controls designed by management to give it reasonable assurance that its internal financial reports are reliable, and the financial statements management prepares for external purposes conform to generally accepted accounting principles. The records of the business must accurately and fairly reflect its transactions in reasonable detail, and procedures must be in place to catch misuses of business assets. Management also must design and maintain “disclosure controls and procedures,” internal processes that are used to ensure that the information disclosed in the reports filed or submitted under the Securities Exchange Act is accurately recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms. Section 404(a) of the Sarbanes-Oxley Act and the SEC’s related implementing rules go on

complainant, a terminal manager, had a realistic belief that the SEC had been provided inflated on-time percentage data that may have inflated the company’s stock price. But there was no evidence that he ever told a superior, a federal officer or a member of Congress that the employer had engaged in questionable activities, so he failed to show a protected activity—he never “blew the whistle.”


219. See 17 C.F.R. § 240.13a-15(f) and 240.15d-15(f) on required controls and procedures for public companies. The SEC believes its definition of “internal control over financial reporting” in those rules is consistent with the description of the internal accounting controls that § 13(b)(2) of the Securities Exchange Act requires. See S.E.C. Release 33-8238, supra note 196; 68 Fed. Reg. 36,636, 36,640 at internal note 53 (June 18, 2002). Information an employee provides to a supervisor, to a federal regulator, or to member of Congress that a practice constitutes an inadequate internal control over financial reporting becomes a complaint that the challenged action violates both an SEC rule and the Securities Exchange Act itself.

220. See 17 C.F.R. § 240.13a-15(e) and § 240.15d-15(e).
to require the managers of a public company to assess the effectiveness of the disclosure control and procedures.\textsuperscript{221}

1. The Platone Decision

\textit{Platone v. FLYi, Inc.},\textsuperscript{222} touches on materiality, and deserves extended analysis. The complainant, a labor relations manager for a now-bankrupt regional airline, had worked previously for the pilot’s union, the Air Line Pilots Association (ALPA).\textsuperscript{223} She claimed the airline fired her for tenaciously trying to ensure that the ALPA reimbursed the airline for flight loss pay.\textsuperscript{224} This was pay about 50 pilots who were members of the ALPA’s Master Executive Council (Council) could receive for time they spent in union meetings or labor-management negotiations when they had been scheduled to fly.\textsuperscript{225} The airline paid the Council members for that time in the first instance, which ALPA then reimbursed to the airline at 120\% to cover the costs and benefits paid to the replacement pilot who actually flew the Council member’s route.\textsuperscript{226}

The airline claimed it fired the complainant ostensibly because she concealed her ongoing romantic relationship with a pilot who had chaired the Council when she was hired (he resigned from that post about three months thereafter).\textsuperscript{227} Airline senior managers believed she had a conflict of interest at the outset of her work, because of her access to the airline’s data and positions on labor matters, and it continued even after the pilot left the Council because managers believed he continued to play an informal role in union issues.\textsuperscript{228} The airline failed to substantiate actual instances of divided loyalties at trial.\textsuperscript{229}

\begin{itemize}
\item \textsuperscript{221} 17 C.F.R. § 240.13a-15(b), §240.15d-15(b).
\item \textsuperscript{222} ARB No. 04-154, ALJ No. 2003-SOX-27 (ARB Sept. 29, 2006).
\item \textsuperscript{223} \textit{id.} at 4.
\item \textsuperscript{224} \textit{id.} at 11.
\item \textsuperscript{225} \textit{id.} at 4.
\item \textsuperscript{226} \textit{id.} at 4, n.19.
\item \textsuperscript{227} \textit{id.} at 6.
\item \textsuperscript{228} ARB No. 04-154, ALJ No. 2003-SOX-27 (ARB Sept. 29, 2006).
\item \textsuperscript{229} \textit{id.} at 12.
\end{itemize}
Flight loss pay was a problem because the pilots were not supposed to schedule themselves to fly when there would be a conflict with union business, i.e., if the union meeting or labor-management negotiating session were set a month or so in advance. It was meant for unavoidable conflicts. But a pilot on the Council could bid to be assigned to fly on a day ALPA business was scheduled, or trade a flight with another pilot to fly on a day he or she originally was to be off, to create a conflict and be paid for a day devoted to union work ("swaps and drops"). The ALPA regarded this as so unethical it was grounds for expulsion from the union, since union members ultimately were liable for the pay.

The airline had no coherent way to track flight pilots dropped for union business, so the complainant developed a system to track and bill the time to the ALPA. After almost three months, using the limited information she could obtain, she detected what looked like abuses of the arrangement by four Council pilots. The ALPA had not been billed for flight loss pay regularly, and was indebted to the airline for several months of it (October through February), which cost the airline between $20,000 and $25,000 per month. The pilot who currently served as Council chairman took offense to the complainant’s dogged pursuit of the issue. After her superior, the airline’s head of labor relations, assigned her to draft a letter about flight loss abuse to ALPA, he declined to send it, because he saw no evidence of intentional wrongdoing by pilots, the letter was too strongly worded, and the current chairman of the Council had assured him that the airline would be reimbursed for the trips.

Cost cutting was a crucial issue for the airline then because more than 80% of its flights were flown for United, which had filed for bankruptcy, so a new contract had to be negotiated with United at

230. Id. at 6.
231. Id.
232. Id. at 7.
233. Id.
235. Id. at 5.
236. Id. at 7.
237. Id. at 8.
lower rates. Negotiations with its pilots for labor concessions were imminent. The complainant believed the head of labor relations went soft on the flight loss pay issue because it funneled money to ALPA negotiators, so they would be more amenable to concessions from the pilots that the airline needed desperately. The complainant believed this conflicted with the airline’s right to be paid by the ALPA for flight loss under the collective bargaining agreement, but she never said so directly to her boss, or any other senior corporate manager.

The administrative law judge found the claimant had a reasonable basis to believe a fraud was being perpetrated on the airline and its shareholders. Shortly before the concessionary contract negotiations were to begin, senior ALPA Council members and the head of labor relations agreed that nothing would be done on the flight loss pay issue. That money therefore came out of the airline’s bottom line. The tracking system the complainant worked on was never implemented, and the airline did not bill the ALPA for the arrearages. At about the same time the current chairman of the Council mentioned to the head of labor relations that the complainant was dating the former Council chairman. In the course of the airline’s investigation of the relationship, the complainant blamed the disclosure of her private life on the APLA’s attempt to retaliate for pursuing the union representatives’ fraud on the airline. She told employees in the human relations department who investigated her that the “pilots-representatives had cheated the company out of money and now were angry with her for raising the issue.”

238. Id. at 3.
239. Id.
241. Id.
242. Id. at 12.
243. Id. at 12.
244. Id.
245. Id.
247. Id. at 12.
248. Id. at 10-11.
detriment of the airline’s shareholders.\textsuperscript{249} The judge ultimately found in the complainant’s favor.\textsuperscript{250}

The Board reversed and dismissed the complaint, limiting its ruling to a determination that no protected activity had been proven.\textsuperscript{251} The Board held that a protected communication must “definitively and specifically” relate to the subject matter of one of the predicate statutes enumerated in 18 U.S.C. § 1514A(a)(1).\textsuperscript{252} The Act does not protect all employee complaints about how a public company spends its money and pays its bills.\textsuperscript{253} The relevant inquiry asks: before the adverse employment action took place, what did the employee communicate to the employer?\textsuperscript{254} Protection does not turn on what the employee alleges in the claim for relief filed with the Secretary of Labor.\textsuperscript{255} Contrary to what she alleged in her OSHA complaint, the Board found the complainant never had informed managers that “the company had created, or had acquiesced in, a scheme to funnel improper payments to members of the union’s master executive council.”\textsuperscript{256} She had raised an issue about the employer’s collection of a debt, worked with more senior executives to resolve the billing problem, and continued other efforts to address the billing issue.\textsuperscript{257} After reviewing the evidence of e-mails and conversations in the record, the Board determined that the complainant did not provide her employer with specific information regarding “any conduct the employee reasonably believe[d] constitutes a violation of 18 U.S.C. §§ 1341 [mail fraud], 1343 [wire fraud], 1344 [bank fraud], or 1348 [securities fraud], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.”\textsuperscript{258}

\textsuperscript{249} Id.
\textsuperscript{250} Id.
\textsuperscript{251} Id. at 13, 17.
\textsuperscript{252} ARB No. 04-154, ALJ No. 2003-SOX-27, 17 (ARB Sept. 29, 2006).
\textsuperscript{253} Id. at 17.
\textsuperscript{254} Id.
\textsuperscript{255} Id.
\textsuperscript{256} Id. at 21, n.146.
\textsuperscript{257} Id. at 19.
\textsuperscript{258} ARB No. 04-154, ALJ No. 2003-SOX-27, 21-22, n.147 (ARB Sept. 29, 2006).
When a SOX whistleblower grounds a complaint on federal mail and (or) wire fraud statutes, "the alleged fraudulent conduct must at least be of a type that would be adverse to investors' interests." The Board supported this with a citation to the preamble to the SOX Act, stating the law is meant "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." The Board determined that the fraudulent scheme, if there was one, was carried out against the APLA by its own Council members. It also held that the complainant never implicated the head of labor relations or any other airline employee in her statements that alleged a fraud against the airline. Had the Board stopped there, its decision would have been in line with disclosure doctrines laid out in its Allen and Henrich cases, and less controversial.

The Board went on to say that the complainant’s allegation that the airline managers violated SEC Rule 10b-5 was baseless where the information she gave to managers at the airline about a potential billing problem did not approximate "any of the basic elements of a claim of securities fraud" [i.e., a material misrepresentation or omission, scienter, a connection to the purchase or sale of a security, reliance on the misrepresentation, economic loss and loss causation]. Nor did she identify a fraudulent scheme "in connection with the purchase or sale of any security," and testified to less than $1,500 in potential losses, which would be unlikely to be considered "material" by a reasonable shareholder. This is inconsistent with the ALJ’s finding that unbilled flight loss pay was more than an order of magnitude higher than that amount each month; the Board may have referred only to amounts paid to a Council member that doubtlessly abused of the flight loss pay arrangement, not the entirety of the monthly reimbursement the ALPA owed.

259. Id. at 15, n.107.
260. Id.
261. Id. at 21.
262. Id.
263. Id.
The comments about Rule 10b-5 are dicta, for after the Board found the airline/employer was not the party harmed by the fraudulent scheme (the ALPA was the injured party), and the employee never communicated any misconduct she reasonably ascribed to an airline officer or employee, the case should have been over.

The implication that a complainant’s disclosures to an employer should cover the basic elements of a Rule 10b-5 action cannot be squared with the elements of a whistleblower claim the Secretary published at 29 C.F.R. § 1980.104(b)(1). For the reasons already explained, it makes no sense to expect the complainant to be a purchaser or seller of securities the employer has issued, or to know what damages purchasers or sellers suffered. What a whistleblower knows is any employment-related damages he or she suffered.

Conflating whistleblower protection proceedings with private causes of action for securities fraud under SEC Rule 10b-5 would limit whistleblower protections only to successful securities frauds, for proof of actual damages is a required element of those district court suits. Such a rule would be fundamentally inconsistent with the Third Circuit’s decision in Passaic Valley Sewerage Commissioners v. Department of Labor\(^{265}\) because it would require that there be an actual, successful fraud for the employee to be protected. This ignores that whistleblowing disclosures can thwart frauds, avoid investor losses, but leave the whistleblower unemployed.

Like most whistleblowers, the complainant had no legal training in the elements of a securities fraud cause of action, to tailor the information she gave to corporate officials to cover each element. The peculiar way the Board expressed itself leaves unclear whether covering at least one element, rather than all, would suffice. Would the result have changed if the complainant had said to the human resources investigators “pilots-representatives had cheated the company shareholders out of money and now were angry with her for raising the issue?” The complainant in the Halloum case specifically had asserted to the SEC and the President of Intel that the delay in paying invoices involved shareholder fraud.\(^{266}\)

\(^{265}\) Passaic Valley Sewerage Commr’s v. Dep’t of Labor, 992 F.2d 474, 478 (3rd Cir. 1993).

In addition, the complainant might have characterized the airline’s haphazard collection of what should have been monthly reimbursements for flight loss pay as a failure of the airline’s internal controls. She may then have been able to obtain protection under the Board’s decision in *Klopfenstein*,\(^\text{267}\) although the airline would be free to prove it would have fired her anyway because of her relationship with the former Council chairman.

The contours of the Board’s position on materiality will become clearer as it adjudicates more cases.

**C. One Alternative Approach to Materiality**

Another approach to materiality at least deserves mention. As has been seen already, some claims for protection proceed in three steps. At the first step, the employee alleges a reasonable belief that the employer is violating a law not on the list of SOX predicate offenses. At the second step, the employee asserts that the potential penalty for the violation if the employer is called to account by the government (in an enforcement action) or by a private party (in civil litigation) will have a quantitatively material effect on the business. The third step claims that the business has left shareholders in the dark about this lurking liability, and so is defrauding them. The unsuccessful complainants in *Nixon*\(^\text{268}\) (about potential violations of environmental laws), *McClendon*\(^\text{269}\) (about potential violations of federal laws on employment taxes), and the two *Harvey* proceedings\(^\text{270}\) (about violations of wage and hour or anti-discrimination laws) sought to frame their arguments in this way. The Board appears to have rejected this effort in one of its *Harvey* decisions as “a mere possibility,”\(^\text{271}\) or in other words as just too speculative.

\(^{267}\) *Klopfenstein*, ARB No. 04-149, ALJ No. 2004-SOX-11 slip op. at 17 & n. 20 (ARB May 31, 2006), discussed *supra* at note 217.


A commentator has suggested a test to determine when an employee’s communications about a perceived violation of law not listed as a predicate statute should qualify as a “protected activity” under the statutory reasonable-belief test.\textsuperscript{272} The test posits that materiality has two elements: (1) the likelihood that the negative event\textsuperscript{273} affecting the financial reporting will actually materialize within a reasonable timeframe and (2) the potential financial impact that would result if and when the event occurred.\textsuperscript{274} Together they represent a sliding scale, the stronger the likelihood that the event will occur, the less financial impact will be required.\textsuperscript{275} The proposal still suffers from the need to demonstrate quantitative materiality while four necessary facts are in doubt: when some regulatory proceeding or lawsuit will be filed; whether it will succeed; the size of the potential penalty or damage award; and the company’s financial position at that future time.\textsuperscript{276} This article argues that no materiality requirement exists, and that violations of non-predicate statutes are legally irrelevant (\textit{i.e.}, immaterial), but practitioners ought to be aware of this alternative (but not altogether promising) approach to materiality.\textsuperscript{277}

\textbf{D. Summary}

The qualitative aspects of materiality have been insufficiently appreciated in securities fraud litigation under §10(b) of the Securities Exchange Act of 1934, so care should be taken before those decisions are applied wholesale to Sarbanes-Oxley whistleblower proceedings. The legislative history of the employee protection provision is consistent with an expansive view of


\textsuperscript{273} These would include a regulatory prosecution seeking remedial action and civil monetary penalties for environmental offenses in Nixon, a tax audit for underpayment of employment taxes and for interest and penalties in McClendon, or a private lawsuit seeking damages for racial discrimination in Harvey.

\textsuperscript{274} Riordan, \textit{supra} note 272 at 108.

\textsuperscript{275} \textit{Id}. at 108-09.

\textsuperscript{276} \textit{Id}. at 109.

\textsuperscript{277} \textit{Id}. at 110.
protected activities, in which the information the employee provides need only be legally relevant (i.e., material) to one of the predicate offense Congress listed in the Act. The Secretary of Labor already has rejected the importation of a quantitative materiality standard into whistleblower proceedings when she adopted the final regulations implementing the Sarbanes-Oxley Act. The statutory language, and the text of the Secretary’s implementing regulations require a complainant to prove neither materiality nor the other liability and damage elements of a securities fraud case to qualify for the statute’s protection. Employees who disclose information with a sincere and objectively reasonable belief that it relates to misconduct qualify for protection.