A Timely Analysis of Legal Developments

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Supreme Court's First Sarbanes-Oxley Decision Promises Expansion of Coverage to Most Privately Held Businesses

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In *Lawson v. FMR LLC*,[1] the Supreme Court massively expanded the scope of the anti-retaliation provision of the Sarbanes-Oxley Act (SOX), from 4,500 publicly held companies to millions of private companies that are "contractors," "subcontractors" or "agents" of a publicly held company. Going forward, privately held employers should be aware that SOX provides a remedy for almost all U.S. employees who suffer adverse employment actions for reporting fraud. Employers should train their management and human resources personnel to identify potential employment issues of this type and remedy them before they become costly litigation.

Background for the *Lawson* Decision

Congress enacted SOX in response to the massive scandals at public companies like Enron in the early 2000s. SOX imposed comprehensive new standards for public companies and their boards, managers and accountants. SOX also contained an anti-retaliation provision that prohibits a public company or an "officer, employee, contractor, subcontractor, or agent of such company" from "discharging, demoting, suspending, threatening, harassing, or in any other manner discriminating" against "an employee," because that employee blew the whistle on mail fraud, wire fraud, bank fraud, securities fraud, shareholder fraud, or any SEC rule or regulation.

Until *Lawson*, no court had addressed the meaning of the term "an employee." In *Lawson*, the plaintiffs worked for private companies that provided services for Fidelity mutual funds. The plaintiffs' actual employers were privately held companies, but served as contractors to the publicly-held mutual funds, which have no employees of their own.

The plaintiffs filed civil actions in the U.S. District Court of Massachusetts under SOX. The first plaintiff claimed that she was forced to resign because she internally raised concerns about cost accounting methodologies related to the mutual funds, while the second plaintiff alleged that his employer terminated him for pointing out inaccuracies in a mutual fund SEC filing. The defendants moved to dismiss, arguing that SOX applies only to employees of public companies, not employees of privately-owned entities (like many mutual funds' investment advisers).

1 No. 12-3, 571 U.S. --- (March 4, 2014).

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The district court denied the defendants' motion, but sent the question to the U.S. Court of Appeals for the First Circuit for immediate review. The First Circuit disagreed with the district court and held in favor of the defendants. It read "an employee" to refer only to an employee of a publicly held company, not employees of private businesses like the plaintiffs. The First Circuit noted that if employees of contractors and subcontractors were included within the scope of SOX, then so too would employees of a publicly held company's "officers," "employees" and "agents," a conclusion the court of appeals declined to reach.

A few months later, the Department of Labor's Administrative Review Board (ARB) reached a different finding. In *Spinner v. David Landau & Associates LLC*, the ARB held that an auditor who was fired by a privately held firm could bring a SOX claim, because the privately held firm had provided compliance services to a public company. The ARB found that the term "an employee" referred not only to employees of the publicly held company, but also employees of its contractors and subcontractors—though not the employees of "officers," "employees" and "agents" of a public company.

The Supreme Court Decision

With this split between a court of appeals and the Department of Labor, the Supreme Court agreed to hear the plaintiffs' appeal in *Lawson*. The Court rejected both the First Circuit's view and that of the ARB, instead reaching the broadest possible interpretation of statutory coverage: that SOX applies to employees of publicly held companies, employees of contractors and subcontractors, and even employees of a public company's "officers," "employees" and "agents."

In reaching this conclusion, the Court started with the anti-retaliation language of SOX. The Court "boiled it down," reducing the anti-retaliation provision to say only that "no contractor may discharge an employee" for blowing the whistle. Simplified in that way, the Court concluded that the "employee" referenced had to be the employee of the contractor, not the employee of the publicly traded company. As further support for this conclusion, the Court noted that SOX says one cannot "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee," and these are all actions that an employer takes against its own employee, not against the employee of another company. SOX also provides for reinstatement, a remedy that a contractor could not grant to another company's employee.

The Court also noted that Congress enacted SOX in the wake of the Enron debacle. In debating that law, Congress observed that Enron's contractors were "complicit in, if not integral to, the shareholder fraud and subsequent cover-up." Enron's fraud continued for so long in part because these contractors were able to retaliate against and even discharge employees who tried to report corporate misconduct, without any legal consequences. Turning to the plaintiffs' situation, the Court also observed that limiting SOX to employees of publicly held companies would essentially exempt the mutual fund industry from the SOX anti-retaliation provisions since publicly held mutual funds do not have any employees and instead are managed by privately held investment advisers. Putting this all together, the Court found that "employee" must include employees of contractors.

One issue of interest to practitioners in this area was whether the Court would grant deference to the ARB's interpretation of SOX. The majority opinion did not issue a ruling on this point, though it was skeptical of the argument that it is the SEC that should interpret SOX rather than the ARB. The three dissenting Justices did say that the ARB's interpretations would not be entitled to deference, thus leaving the question open for another day.

While the *Lawson* case presented a "mainstream application" of SOX—finance professionals allegedly blowing the whistle on fraud at a mutual fund—the Court's decision sweeps far, far wider. First, the Court did not adopt any limitation to the word "contractor." Thus, SOX could reach not only employees of law firms, accounting firms or investment advisers, but also employees of companies that have nothing to do with compliance or fraud, such as cleaning or construction companies. Second, SOX references "subcontractors" of publicly held companies. Even if a company only did business with other private companies, its employees could still file claims under SOX if the company contracted with a company that contracted with a public company. In short, virtually every business in the United States could face liability under SOX's anti-retaliation section. Even more broadly, SOX also prohibits "officers," "employees" and "agents" of publicly held companies from retaliating against their employees. Thus, if a parent who works at a publicly held company hires a babysitter, that babysitter could have a federal cause of action against that parent under SOX. Similarly, a housekeeper or gardener working for an officer of a publicly held company would be eligible to file a SOX claim for retaliation.

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These somewhat remarkable outcomes were pointed out by a vigorous dissent in *Lawson*. The majority opinion acknowledged that "housekeepers or gardeners" would fall within SOX's protections, but dismissed these concerns as "more theoretical than real." As for the massive number of privately held companies that could now face SOX litigation, the Court found that those concerns "are [no] more than hypothetical." The Court concluded, "if we are wrong," then "Congress can easily fix the problem by amending [SOX]."

Impact of the *Lawson* Decision on Privately Held Businesses

Unfortunately for millions of privately held companies, the costs of defending against a SOX claim and the potential damages available are neither "theoretical" nor "hypothetical." SOX has a particularly lengthy and complicated procedure, which allows claimants to have multiple bites at the apple. A case is first investigated by OSHA, which determines whether there is probable cause to support the allegations. If the claimant loses at this phase, s/he can then seek further review after discovery, through a *de novo* hearing before an administrative law judge. If the claimant loses again, the case can be appealed to the ARB for another review. Further, before a final decision is reached by the ARB, the claimant can at any time remove the case to federal district court for *de novo* review at trial, even if the case has already been decided either by OSHA itself or a Department of Labor administrative law judge. The cost of defending against even a meritless claim at these multiple levels can be daunting. Furthermore, if the claimant prevails, then s/he can recover "all relief necessary to make the employee whole," which can include back pay, compensatory damages, attorneys' fees, and possibly even reinstatement.

To minimize the risk, privately held businesses in America must immediately take action to revise and, in some cases, implement new strategies to foster a culture of compliance and guard against the prospect of retaliation. Fortunately, the past decade has seen a revolution in the evolution of new products, services and technologies designed to assist businesses in strengthening their compliance programs. Because SOX now applies broadly to millions more companies in America, many of those will have to at least consider implementing a more robust and structured compliance program. These measures include adopting compliance policies and creating systems whereby employees can make good faith reports of concerns regarding financial misconduct and the company can promptly investigate those complaints and take any necessary corrective action. Further, human resources departments and front-line managers in privately held businesses should be trained on identification of financial misconduct, how to marshal the resources necessary to investigate financial misconduct, and how to protect legitimate whistleblowers from retaliation at the hands of dishonest managers.

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