The Duty of Loyalty: Whistleblowing

Chapter 2

The men the American people admire most extravagantly are the most daring liars; the men they detest most violently are those who try to tell them the truth.

— H.L. Mencken

The woods were filled with smart people at Enron, but there were really no wise people, or people who could say "this is enough."

— John Olson, energy industry analyst

What matters . . . is not what a person is, but how closely his many personae mesh with the organizational ideal; not his willingness to stand by his actions, but his agility in avoiding blame; not what he stands for, but whom he stands with in the labyrinths of his organization.

— Robert Jackall, *Moral Mazes: Bureaucracy and Managerial Work*

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This chapter is about people who feel morally driven to call attention to problems they see at work, at the risk of disturbing the status quo, alienating others, and bringing damaging repercussions upon themselves and their families. It is about being caught between conflicting loyalties—to one's employer, and to one's conscience—the dilemma faced by a person who must decide whether to become a "whistleblower."

Whistleblowers are people who decide to report unethical or illegal activities under the control of their employers. They may be working for private companies, nonprofit organizations, or for the government. They may disclose information inside or outside their organizations—to supervisors, regulators, or to the media. What unites all whistleblowing is the urge to bring a disturbing situation to light, the urge to bring about some corrective change. The motivating issues range from airline, nuclear, and environmental safety to the kinds of improper accounting practices that brought down Enron and Worldcom.

This chapter explains the legal doctrine known as **employment-at-will,** which gives employers broad discretion to fire employees "for a good reason, a bad reason, or no reason at all." Although twentieth-century exceptions to this rule have blunted its harshness, the cases demonstrate that whistleblowers often experience retaliation and have little recourse under the common law. Statutes passed in all 50 states provide some protection for employees, but wide variation exists among them; we will look at one of them. We turn to the Sarbanes-Oxley Act—passed in the wake of financial and accounting scandals—to assess the degree to which it protects corporate whistleblowers. And we consider how First Amendment freedom of speech has been interpreted by the Supreme Court to give public employees limited rights to blow the whistle.

We examine the complex concept of loyalty in the workplace—the crosscurrents of loyalty to an employer, to a professional code, to a personal moral compass. In the aftermath of the collapse of Enron, we ask why those with "watchdog" responsibilities, such as accountants and securities analysts, allowed their independent judgment to be compromised.

Whistleblowing can wreak havoc. Those who insist that bad news must be heard may damage the reputations of their employers; they risk having their own careers destroyed. In this chapter we see that in spite of the costs, we may yet appreciate the role of the dissenters in serving the public interest when the checkpoints of our systems fail us.

In 1993, Dr. Donn Milton was hired by a nonprofit scientific research organization, IIT Research Institute (IITRI), to oversee a contract with the federal government. By 1995, his responsibilities widened as he was promoted to vice president of IITRI's Advanced Technology Group. Like other nonprofits, IITRI had been established with a public mission and was classified as tax exempt. As Dr. Milton discovered, however, the organization was "abusing its tax-exempt status by failing to report . . . taxable income generated by the substantial portion of . . . business that did not constitute scientific research in the public interest."

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DONN MILTON, DR., V. IIT RESEARCH INSTITUTE

Fourth Circuit Court of Appeals, 1998
138 F.3d 519

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WILKINSON, Chief Judge.

Milton voiced his concerns to IITRI management, to no avail. In 1995, after similar allegations by a competitor, IITRI initiated an internal examination of the issue. In connection with this inquiry, IITRI received an outside opinion letter concluding that the IRS could well deem some of IITRI's projects unrelated business activities and that the income from these activities was likely taxable. Milton urged the President of IITRI, John Scott, to take action in response to the letter, but Scott refused. Milton raised the issue with IITRI's Treasurer, who agreed that IITRI was improperly claiming unrelated business income as exempt income and promised to remedy the problem after Scott's then-imminent retirement. However, this retirement did not come to pass. Finally, in November 1996, when Scott falsely indicated to IITRI's board of governors that IITRI had no problem with unrelated business income, Milton reported the falsity of these statements to Lew Collens, Chairman of the Board of IITRI, and informed Collens of the opinion letter.

On January 1, 1997, Scott called Milton at home and informed him that he had been relieved of his Group Vice President title and demoted to his previous position as supervisor of TSMI. On February 12, 1997, Milton's attorney contacted IITRI about the demotion, alleging that it was unlawful retaliation for informing management of IITRI's unlawful practices. Two days later . . . Milton received a letter from Collens terminating his employment with IITRI.

[The general legal rule is that employees can be fired with or without cause, but there is an exception: under the tort of "wrongful discharge," an employee can argue that the firing clearly conflicts with "public policy."]

Milton filed suit against IITRI . . . for wrongful discharge. . . .

Maryland has recognized a "narrow exception" to the general rule of at-will employment: "discharge may not contravene a clear mandate of public policy." Maryland courts have found such a mandate only in limited circumstances: (1) "where an employee has been fired for refusing to violate the law . . ."and (2) "where [an] employee has been terminated for exercising a specific legal right or duty. . . ."

Milton makes no claim that he was asked to break the law. He had no role in preparing IITRI's submissions to the IRS and no responsibility for their content. Instead, Milton claims he was fired for fulfilling his fiduciary duty as a corporate officer to inform IITRI's Board of activities

injurious to the corporation's long-term interests. . . . Maryland law does provide a wrongful discharge cause of action for employees who are terminated because they perform their "statutorily prescribed duty." However, this exception to the norm of at-will employment has been construed narrowly by the Maryland courts and is not available in Milton's case. . . . [I]n *Thompson v. Memorial Hospital,* the . . . court . . . held that, because a hospital employee was not chargeable with the hospital's regulatory duty to report misadministration of radiation, he did not state a claim for wrongful discharge when he was fired for making such a report. By contrast, in *Bleich v. Florence Crittenden Services* (1993), the court recognized that an educator terminated for filing a report of child abuse and neglect, as she was explicitly required to do by Maryland law, did state a claim for wrongful discharge. These cases indicate that, for Milton to recover, it is not enough that *someone* at IITRI was responsible for correcting its tax filings or that the corporation may have been liable for tax fraud. This responsibility was never Milton's, nor did he face any potential liability for failing to discharge it, so his claim fails.

Milton argues that his fiduciary obligations as an officer of IITRI supply the legal duty that was missing in *Thompson* and that supported the cause of action in *Bleich.* But in fact Milton labored under no "specific legal duty," to report IITRI's tax fraud to the Board. He points to no statute or other legal source that imposes on him a specific duty to report, and the broad fiduciary obligations of "care and loyalty" he alleges are simply too general to qualify as a specific legal duty that will support the claim that his discharge violates a "clear mandate of public policy." Recognizing whistleblower protection for every corporate officer fired in the wake of a disagreement over an employer's business practices would transform this "narrow exception" into a broad one indeed.

This search for a specific legal duty is no mere formality. Rather it limits judicial forays into the wilderness of discerning "public policy" without clear direction from a legislative or regulatory source

[Judgment of dismissal affirmed.]

• QUESTIONS •

1. In legal terms, why did Milton lose?

2. The court here expresses concern that, if Dr. Milton were permitted to win, it would open a "Pandora's box," with "every corporate officer fired in the wake of a disagreement over an employer's business practices" a potential successful plaintiff. Reframe this argument. What is at stake here for employers?

3. This case is about conflicting loyalties. Make a list of the stakeholders (those primarily affected by the situation). Now describe the various links of loyalty—who felt responsible to whom? Analyze the situation using the ethical theories in Chapter 1. Did Milton do the right thing? How does the decision to fire him look through the lens of ethical theory?

4. In late 2001, the seventh largest corporation in the United States, Enron Corp., filed for the largest bankruptcy in U.S. history. The Texas energy conglomerate suffered a complete and sudden collapse—but not before a handful of its executives sold more than $1 billion of their shares. Meanwhile, thousands of Enron employees whose retirement plans were tied to the value of the company's stock were barred from selling, and had to watch their savings drain away. Enron had been overstating its profits by nearly $600 million over five years, in statements that its auditors, Arthur Anderson, approved. Within a series of complicated off-the-books partnerships, the company was able to conceal major losses, making Enron stock continue to seem a safe bet. Such "creative accounting" is often legal and not unusual; many businesses use these techniques to enhance their perceived financial health.

A few months before Enron laid off more than 4,000 employees and filed for bankruptcy, Sherron Watkins, a 42-year-old vice president of corporate development at Enron, wrote to CEO Kenneth Lay, warning that improper accounting practices threatened to bring

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the company down. "I am incredibly nervous that we will implode in a wave of accounting scandals," she wrote. Suppose Watkins had been fired for blowing the whistle, and then sued for wrongful discharge. If her firing took place in Maryland, who would probably win and why?[1]

5. Should it make any difference how the whistle is blown—internally or externally? Dr. Milton tried to discuss his concerns inside his organization with the president, the treasurer, and eventually with the board of directors. Former Enron executive Maureen Casteneda gave an interview to ABC News in late January 2002, in which she described ongoing, large-scale document shredding at the company. When might it be ethically appropriate to blow the whistle (a) internally; (b) to the enforcing authorities, such as SEC regulators; and (c) to the media?

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EMPLOYMENT-AT-WILL

I am in charge here. My word is law and your wishes mean nothing. If I dislike anything about you—the way you tie your shoes, comb your hair or fart, you're back in the streets, get it?

— Charles Bukowski, *Ham and Rye*

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Employment-at-will is a relatively recent common law development. It gives employers unfettered power to "dismiss their employees at will for good cause, for no cause, or even for cause morally wrong, without being thereby guilty of a legal wrong."[2] The theory crystallized at the time of the industrial revolution in the United States when it became advantageous for employers to have the ability to bring on or to shed employees, depending on the fluctuating demands of the market.

The economic philosophy of laissez-faire provided theoretical support for employment-at-will. Its legal underpinnings consisted mainly of "freedom of contract," the idea that individuals are free to choose how to dispose of what they own, including their labor, as they see fit, and that the voluntary contractual promises they make are legitimately enforceable.

Employment-at-will is a "two-way street," allowing both employers and employees to sever their relationship without cause. As the Supreme Court put it in a 1908 case striking down early labor legislation:

> *The right of an employee to quit the service of the employer, for whatever reason, is the same as the right of the employer, for whatever reason, to dispense with the services of such employee.*[3]

Practically speaking, however, while a business may suffer temporary disruption when an employee quits, it is not uncommon for an employee to be devastated by dismissal; this has been

1 As a matter of fact, Watkins was not fired for sending the seven-page memo. The company decided to "investigate" her concerns, hiring for that purpose Vinson & Elkins, the same law firm that helped set up some of the transactions Sherron Watkins was challenging. Enron told this firm to limit its review, and not to examine the underlying accounting of the partnerships. Not surprisingly, the report concluded that the accounting procedures were "legitimate." Meanwhile, Mr. Lay and others continued to assure their employees about the stock values, although at the same time these executives were selling their own holdings.

2 *Payne v. Webster & Atlantic R.R. Co.,* 81 Tenn. 507, 519–20 (1884).

3 *Adair v. United States,* 208 U.S. 161, 174–75 (1908). This quote is reminiscent of Anatole France, who wrote: "The Law, in its majestic equality, forbids the rich, as well as the poor, to sleep under the bridges, to beg in the streets, and to steal bread."

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described as the "organizational equivalent of capital punishment." While an employer faces the cost of finding and training a replacement, a dismissed employee faces greater, multifaceted costs. Most obvious is the loss of present income. There is, with loss of seniority and retirement benefits, future economic hardship.[4] The employee may be considered too old or too specialized to be hired anew, or may have to move to look for work. Interviewing for a new position may be an uphill battle with an uneven employment history. And in the case of a whistleblower, the ex-employer may have spread the word that he was a troublemaker; he may be blackballed throughout an entire industry.

Whatever the actual circumstances of a dismissal, it is not easy for employees to keep their self-respect intact. Isolated, having been taken off the "team," they may be anxious over an uncertain future.

Exceptions to the Rule

The earliest adjustments to the doctrine of employment-at-will were made as workers fought for the right to organize and form unions. In 1935, they were guaranteed these rights, and not long after, the U.S. Supreme Court announced that an employer could not use employment-at-will as a means of "intimidat[ing] or coerc[ing] its employees with respect to their self organization."[5] In other words, employees could not be fired as punishment for attempting to organize themselves into unions. Although at this writing only a fairly narrow slice of the U.S. workforce is unionized,[6]collective bargaining agreements typically cut against employment-at-will, protecting workers from being fired except for "good cause."

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Beginning in the 1960s, federal civil rights laws created remedies against employers who fire workers because of their race, national origin, color, religion, sex, age, or disability.[7] In the 1970s and 1980s, federal and state statutes included protection from retaliation for employees who report violations of environmental or workplace safety laws, for example.[8] And in 2002 Congress passed corporate fraud reform legislation with whistleblower provisions protecting those who report financial misconduct in publicly traded companies. This law is known as Sarbanes-Oxley, or SOX.

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The common law, too, has evolved to soften the harsher effects of employment-at-will. In some states, courts have set limits by means of contract law. There are two main approaches: (1) to imply a promise of "good faith and fair dealing" in the contract of employment, or (2) to imply contractual terms (not to dismiss except for good cause, for instance) from an employer's handbook, policy statement, or behavior. However, only a handful of states use the first approach. And, although the second approach has been recognized by most states, employers are on notice, and unlikely to make any express or implied promises that might be interpreted to cut

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4 The National Bureau of Economic Research reports that those who change employers twice at ages 41 and 51 will reduce their pensions by 57 percent.

5 *NLRB v. Jones & Laughlin Steel Corp.,* 301 U.S. 1, 45–46 (1937).

6 According to the Bureau of Labor Statistics, for the past 20 years, union membership in the United States has been declining steadily. In 2003, under 13 percent of the U.S. workforce was unionized. http://www.bls.gov/news.release/union2.nr0.htm

7 For example, *Civil Rights Act of 1964,* 42 U.S.C. Sec. 2000e-2a (1976); *Age Discrimination in Employment Act of 1967,* 29 U.S.C. Sec. 623(a) (1976); *Americans with Disabilities Act,* 42 U.S.C. Sec. 12112(b)(5)(A). Civil rights laws are discussed more fully in Chapter 4. Most states have similar laws, and some of these go further than the federal statutes, protecting employees against discrimination on the basis of family status or sexual orientation, for example.

8 Federal laws include the *Toxic Substances Control Act,* 15 U.S.C. Sec. 2622(a) (1988); *Occupational Safety and Health Act,* Sec. 660(c)(1) (1988); *Water Pollution Control Act,* 33 U.S.C. Sec. 1367(a) (1988); *Safe Drinking Water Act,* 42 U.S.C.A. Sec. 300j-9(i)(1); *Energy Reorganization Act,* 42 U.S.C. Sec. 5851(a)(3) (1982); *Solid Waste Disposal Act,* 42 U.S.C. Sec. 6971(a) (1982); *Comprehensive Environmental Response, Compensation, and Liability Act,* Sec. 99610(a); *Clean Air Act* Sec. 7622(a).

against employment-at-will. In fact, they are more likely to promise the reverse, as in the following paragraph, recommended for inclusion in employment handbooks for law firms:

> *Your employment with the Firm is voluntarily entered into and you are free to resign at any time. Similarly, the Firm is free to conclude an employment relationship with you where it believes it is in the Firm's best interest at any time. It should be recognized that neither you, nor we, have entered into any contract of employment, express or implied. Our relationship is and will be always one of voluntary employment "at will."*[9]

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Tort law has provided another means of making inroads into employment-at-will, offering a plaintiff the chance to convince a jury to award substantial money damages. For the past 35 years, most U.S. state courts have been shaping the tort of "wrongful discharge," a firing that contradicts "public policy"—in other words, a dismissal that undermines what is beneficial to society in general.

The problem has been how to define public policy.[10] As with contract law, this exception to employment-at-will has been developing simultaneously in different states, producing a crazy quilt of different rules. Most state courts are comfortable looking to the legislature—to laws that have already been passed—for guidance. For instance, they will protect from retaliation employees who have simply exercised their legal rights to file a worker's compensation or a sexual harassment claim,[11] or who have merely performed their legal duty to serve on a jury.[12] And, if employers put their employees "between a rock and a hard place," expecting them to participate in breaking the law or be fired, most courts would again see a violation of public policy, triggering the tort of wrongful discharge.[13] For example, suppose you were an employee of Arthur Andersen, and your supervisor told you to delete computer files related to the government investigation of Enron. Once the SEC subpoenas were issued, destroying those files would amount to obstruction of justice. So, if you refused to destroy then and were fired for that, you would succeed in a suit for wrongful discharge.

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But some states do not recognize the tort at all. In New York, for instance, while an employer could be fined for refusing to allow an employee time for jury service, the employee could not then sue for wrongful discharge.[14] As we have seen, other jurisdictions, such as Maryland, are conservative in identifying violations of public policy.

Inconsistencies like these complicate the risk for whistleblowers. They have noticed a situation at work that troubles them. It may be illegal; it may be "merely" unethical; it may be one they are expected to participate in; it may be one they are expected to ignore; it may involve a statute that carries protection for whistleblowers; it may not. Whistleblowers react first, and must worry about the reach of "public policy" later. Characteristically unable to remain passive in the face of what they believe is wrong, they speak out. Research reveals that whistleblowers are typically long-term, highly loyal employees who feel strongly that their companies should do the right thing, and who tend to disclose to outsiders only after trying to make headway

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9 Victor Schachter, "The Promise of Partnership," *National Law Journal,* October 8, 1984, p. 15.

10 Public policy is generally understood to mean that which benefits society as a whole. But this is a fuzzy concept indeed, and very likely to mirror the personal and political beliefs of individual judges. As one commentator put it, "Public policy is the unruly horse of the law."

11 *Frampton v. Central Indiana Gas Co.,* 297 N.E.2d 425 (Indiana 1973). Plaintiff fired for filing a worker's compensation claim.

12 *Reuther v. Fowler & Williams,* 386 A.2d 119 (Pa. 1978). Plaintiff fired for jury service.

13 For example, in *Petermann v. Int'l. Brotherhood of Teamsters,* 344 P.2d 25 (1969), plaintiff was instructed by his employer to lie when testifying before a legislative investigatory committee. He refused and was fired. The court allowed his suit for wrongful discharge, describing public policy as "that principle of law which holds that no citizen can lawfully do that which has a tendency to be injurious to the public or against the public good." *Id.* at 27.

14 *Di Blasi v. Traffax Traffic Network,* 681 N.Y.S.2d 147 (N.Y. App. Div 1998).

internally.[15] The whistleblower profile is such that, if nothing is done to respond to their internal complaints, they often feel compelled to disclose to authorities outside the company—even to the media. In any case, they are taking the chance that they will not be covered under the wrongful discharge exception to employment-at-will. As one commentator put it, effectively, those who blow the whistle "very often must choose between silence and driving over a cliff."[16]

The Mayor: *We shall expect you, on further investigation, to come to the conclusion that the situation is not nearly as pressing or as dangerous as you had at first imagined.*

Dr. Stockmann: *Oh! You expect that of me, do you?*

The Mayor: *Furthermore we will expect you to make a public statement expressing your faith in the management's integrity and in their intention to take thorough and conscientious steps to remedy any possible defects.*

Dr. Stockmann: *But that's out of the question, Peter. No amount of patching or tinkering can put this matter right; I tell you I know! It is my firm and unalterable conviction—*

The Mayor: *As a member of the staff you have no right to personal convictions.*

Dr. Stockmann: (With a start): *No right to—?*

The Mayor: *Not as a member of the staff—no! As a private individual—that's of course another matter. But as a subordinate in the employ of the Baths you have no right to openly express convictions opposed to those of your superiors.*

Dr. Stockmann: *This is too much! Do you mean to tell me that as a doctor—a scientific man—I have no right to—!*

The Mayor: *But this is not purely a scientific matter; there are other questions involved—technical and economic questions.*

Dr. Stockmann: *To hell with all that! I insist that I am free to speak my mind on any and all questions!*

— Henrik Ibsen, *An Enemy of the People*

In the next case, the plaintiff is a doctor caught in a conflict between what her employer expects her to do, and what she feels is in line with her professional ethical responsibilities.

Pierce v. Ortho Pharmaceutical Corp.

Supreme Court of New Jersey, 1980
417 A.2d 505

POLLOCK, J.

This case presents the question whether an employee-at-will has a cause of action against her employer to recover damages for the termination of her employment following her refusal to continue a project she viewed as medically unethical. . . .

Ortho specializes in the development and manufacture of therapeutic and reproductive drugs. Dr. Pierce is a medical doctor who was first employed by Ortho in 1971 as an Associate Director of Medical Research. She signed no contract except a secrecy agreement, and her

15 Marlene Winfield, "Whistleblowers as Corporate Safety Net," in *Whistleblowing: Subversion or Corporate Citizenship?* 21, 22 (New York, NY: St. Martin's Press, 1994).

16 Joseph Henkert, "Management's Hat Trick: Misuse of 'Engineering Judgment' in the Challenger Incident," 10 *J. Bus. Ethics* 617, 619 (1991).

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employment was not for a fixed term. She was an employee-at-will. In 1973, she became the Director of Medical Research/Therapeutics, one of three major sections of the Medical Research Department. Her primary responsibilities were to oversee development of therapeutic drugs and to establish procedures for testing those drugs for safety, effectiveness, and marketability. Her immediate supervisor was Dr. Samuel Pasquale, Executive Medical Director.

In the spring of 1975, Dr. Pierce was the only medical doctor on a project team developing loperamide, a liquid drug for treatment of diarrhea in infants, children, and elderly persons. The proposed formulation contained saccharin. Although the concentration was consistent with the formula for loperamide marketed in Europe, the project team agreed that the formula was unsuitable for use in the United States.[17] An alternative formulation containing less saccharin might have been developed within approximately three months.

By March 28, however, the project team, except for Dr. Pierce, decided to continue with the development of loperamide. That decision was made apparently in response to a directive from the Marketing Division of Ortho. This decision meant that Ortho would file an investigational new drug application (IND) with the Federal Food and Drug Administration (FDA), continuing laboratory studies on loperamide, and begin work on a formulation. . . .

Dr. Pierce . . . continued to oppose the work being done on loperamide at Ortho. On April 21, 1975, she sent a memorandum to the project team expressing her disagreement with its decision to proceed. . . . In her opinion, there was no justification for seeking FDA permission to use the drug in light of medical controversy over the safety of saccharin.

Dr. Pierce met with Dr. Pasquale on May 9 and informed him that she disagreed with the decision to file an IND with the FDA. . . . She concluded that the risk that saccharin might be harmful should preclude testing the formula on children or elderly persons, especially when an alternative formulation might soon be available. . . .

After their meeting on May 9, Dr. Pasquale informed Dr. Pierce that she would no longer be assigned to the loperamide project. On May 14, Dr. Pasquale asked Dr. Pierce to choose other projects. . . . She felt she was being demoted, even though her salary would not be decreased. Dr. Pierce [submitted a] letter of resignation. . . . [This is called "constructive discharge," the legal equivalent of being fired.]

Dr. Pierce claimed damages for the termination of her employment. Her complaint alleged: "The Defendant, its agents, servants and employees requested and demanded Plaintiff follow a course of action and behavior which was impossible for Plaintiff to follow because of the Hippocratic oath she had taken, because of the ethical standards by which she was governed as a physician, and because of the regulatory schemes, both federal and state, statutory and case law, for the protection of the public in the field of health and human well-being, which schemes Plaintiff believed she should honor. . . ."

Under the common law, in the absence of an employment contract, employers or employees have been free to terminate the employment relationship with or without cause. . . .

Commentators have questioned the compatibility of the traditional at-will doctrine with the realities of modern economics and employment practices. . . . The common law rule has been modified by the enactment of labor relations legislation [prohibiting employers from firing workers because they organize or join a union]. . . .

Recently [many] states have recognized a common law cause of action for employees-at-will who were discharged for reasons that were in some way "wrongful." The courts in those jurisdictions have taken varied approaches, some recognizing the action in tort, some in contract. Nearly all jurisdictions link the success of the wrongful discharged employee's action to proof that the discharge violated public policy. . . .

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17 The group's toxicologist, for instance, noted that saccharin was a "slow carcinogen"; it had produced benign and malignant tumors in test animals after 17 years. The harm it might cause would be obvious only after a long period of time, and "any intentional exposure of any segment of the human population to a potential carcinogen is not in the best interest of public health of the Ortho Pharmaceutical Corporation."

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In recognizing a cause of action to provide a remedy for employees who are wrongfully discharged, we must balance the interests of the employee, the employer, and the public. Employees have an interest in knowing they will not be discharged for exercising their legal rights. Employers have an interest in knowing they can run their businesses as they see fit as long as their conduct is consistent with public policy. The public has an interest in employment stability and in discouraging frivolous lawsuits by dissatisfied employees.

Although the contours of an exception are important to all employees-at-will, this case focuses on the special considerations arising out of the right to fire an employee-at-will who is a member of a recognized profession. One writer has described the predicament that may confront a professional employed by a large corporation: Consider, for example, the plight of an engineer who is told that he will lose his job unless he falsifies his data or conclusions, or unless he approves a product which does not conform to specifications or meet minimum standards . . . and the predicament of an accountant who is told to falsify his employer's profit and loss statement in order to enable the employer to obtain credit.

Employees who are professionals owe a special duty to abide not only by federal and state law, but also by the recognized codes of ethics of their professions. That duty may oblige them to decline to perform acts required by their employers. However, an employee should not have the right to prevent his or her employer from pursuing its business because the employee perceives that a particular business decision violates the employee's personal morals, as distinguished from the recognized code of ethics of the employee's profession.

We hold that an employee has a cause of action for wrongful discharge when the discharge is contrary to a clear mandate of public policy. The sources of public policy include legislation; administrative rules, regulations or decisions; and judicial decisions. In certain instances, a professional code of ethics may contain an expression of public policy. However, not all such sources express a clear mandate of public policy. For example, a code of ethics designed to serve only the interests of a profession or an administrative regulation concerned with technical matters probably would not be sufficient. Absent legislation, the judiciary must define the cause of action in case-by-case determinations. . . . [U]nless an employee-at-will identifies a specific expression of public policy, he may be discharged with or without cause.

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[B]efore loperamide could be tested on humans, an IND had to be submitted to the FDA to obtain approval for such testing. The IND must contain complete manufacturing specifications, details of pre-clinical studies [testing on animals] which demonstrate the safe use of the drug, and a description of proposed clinical studies. The FDA then has 30 days to withhold approval of testing. Since no IND had been filed here, and even giving Dr. Pierce the benefit of all doubt regarding her allegations, it is clear that clinical testing of loperamide on humans was not imminent.

Dr. Pierce argues that by continuing to perform research on loperamide she would have been forced to violate professional medical ethics expressed in the Hippocratic oath. She cites the part of the oath that reads: "I will prescribe regimen for the good of my patients according to my ability and my judgment and never do harm to anyone." Clearly, the general language of the oath does not prohibit specifically research that does not involve tests on humans and that cannot lead to such tests without governmental approval.

We note that Dr. Pierce did not rely on or allege violation of any other standards, including the "codes of professional ethics" advanced by the dissent. Similarly, she did not allege that continuing her research would constitute an act of medical malpractice or violate any statute. . . .

The case would be far different if Ortho had filed the IND, the FDA had disapproved it, and Ortho insisted on testing the drug on humans. . . .

[I]mplicit in Dr. Pierce's position is the contention that Dr. Pasquale and Ortho were obliged to accept her opinion. Dr. Pierce contends, in effect, that Ortho should have stopped research on loperamide because of her opinion about the controversial nature of the drug.

Dr. Pierce espouses a doctrine that would lead to disorder in drug research. . . . Chaos would result if a single doctor engaged in research were allowed to determine, according to his or

her individual conscience, whether a project should continue. An employee does not have a right to continued employment when he or she refuses to conduct research simply because it would contravene his or her personal morals. An employee-at-will who refuses to work for an employer in answer to a call of conscience should recognize that other employees and their employer might heed a different call. However, nothing in this opinion should be construed to restrict the right of an employee-at-will to refuse to work on a project that he or she believes is unethical. . . .

Under these circumstances, we conclude that the Hippocratic oath does not contain a clear mandate of public policy that prevented Dr. Pierce from continuing her research on loperamide. To hold otherwise would seriously impair the ability of drug manufacturers to develop new drugs according to their best judgment.

The legislative and regulatory framework pertaining to drug development reflects a public policy that research involving testing on humans may proceed with FDA approval. The public has an interest in the development of drugs, subject to the approval of a responsible management and the FDA, to protect and promote the health of mankind. . . .

[Appellate division judgment for the plaintiff is reversed and the case is remanded.]

PASHMAN, J., dissenting.

The majority's analysis recognizes that the ethical goals of professional conduct are of inestimable social value. By maintaining informed standards of conduct, licensed professions bring to the problems of their public responsibilities the same expertise that marks their calling. The integrity of codes of professional conduct that result from this regulation deserves judicial protection from undue economic pressure. Employers are a potential source of this pressure, for they can provide or withhold until today, at their whim, job security and the means of enhancing a professional's reputation. Thus, I completely agree with the majority's ruling that "an employee has a cause of action for wrongful discharge when the discharge is contrary to a clear mandate of public policy" as expressed in a "professional code of ethics."

The Court pronounces this rule for the first time today. One would think that it would therefore afford plaintiff an opportunity to seek relief within the confines of this newly announced cause of action. By ordering the grant of summary judgment for defendant, however, the majority apparently believes that such an opportunity would be an exercise in futility. I fail to see how the majority reaches this conclusion. There are a number of detailed, recognized codes of medical ethics that proscribe participation in clinical experimentation when a doctor perceives an unreasonable threat to human health. Any one of these codes could provide the "clear mandate of public policy" that the majority requires.

Three other points made by the majority require discussion. . . . The first is the majority's characterization of the effect of plaintiff's ethical position. It appears to believe that Dr. Pierce had the power to determine whether defendant's proposed development program would continue at all. This is not the case, nor is plaintiff claiming the right to halt defendant's developmental efforts. [P]laintiff claims only the right to her professional autonomy. She contends that she may not be discharged for expressing her view that the clinical program is unethical or for refusing to continue her participation in the project. She has done nothing else to impede continued development of defendant's proposal; moreover, it is undisputed that defendant was able to continue its program by reassigning personnel. Thus, the majority's view that granting doctors a right to be free from abusive discharges would confer on any one of them complete veto power over desirable drug development, is ill-conceived.

The second point concerns the role of governmental approval of the proposed experimental program. In apparent ignorance of the past failures of official regulation to safeguard against pharmaceutical horrors, the majority implies that the necessity for administrative approval for human testing eliminates the need for active, ethical professionals within the drug industry. But we do not know whether the United States Food and Drug Administration (FDA) would be aware of the safer alternative to the proposed drug when it would pass upon defendant's application for the more hazardous formula. The majority professes no such knowledge. We must therefore assume the FDA would have been left in ignorance. This highlights the need for ethically autonomous professionals within the pharmaceutical industry. . . .

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The final point to which I must respond is the majority's observation that plaintiff expressed her opposition prematurely, before the FDA had approved clinical experimentation. Essentially, the majority holds that a professional employee may not express a refusal to engage in illegal or clearly unethical conduct until his actual participation and the resulting harm is imminent. This principle grants little protection to the ethical autonomy of professionals that the majority proclaims. Would the majority have Dr. Pierce wait until the first infant was placed before her, ready to receive the first dose of a drug containing 44 times the concentration of saccharin permitted in 12 ounces of soda?

I respectfully dissent.

• QUESTIONS •

1. The *Pierce* majority announces a new "cause of action in New Jersey for wrongful discharge when the discharge is contrary to a clear mandate of public policy." Such a mandate, it goes on to say, could be found in a professional code of ethics, yet Dr. Pierce had failed to identify one in her complaint with enough specificity. How does the dissenting judge respond to this point? Do Dr. Pierce's professional medical ethics resemble any of the ethical theories in Chapter 1?

2. What is the procedure for obtaining FDA approval of a new drug? Do you agree with the majority that when Dr. Pierce stopped working on the loperamide project the risk to human test subjects was not "imminent"?

3. Surveying the interests at stake in the case, the *Pierce* majority states:

> *[W]e must balance the interests of the employee, the employer, and the public. Employees have an interest in knowing they will not be discharged for exercising their legal rights. Employers have an interest in knowing they can run their businesses as they see fit as long as their conduct is consistent with public policy. The public has an interest in employment stability and in discouraging frivolous lawsuits by dissatisfied employees.*

Are there any important stakeholder interests not mentioned here?

4. The dissent mentions "past failures of official regulation to safeguard against pharmaceutical horrors." There have been more recent failures. Since 2000, the cholesterol-lowering Baycol caused muscle tissue breakdown, the diet drug Fen-Phen led to lung and heart disorders, antidepressants like Zoloft and Prozac caused some children to commit suicide, and the painkiller Vioxx was found to double the risk of heart attack. In each instance, there was evidence that the pharmaceutical firms had evidence suggesting serious problems with drugs that were in development or had already been brought to market. By the time Merck recalled Vioxx, in late 2004, there were congressional hearings underway. A doctor in the FDA's Office of Drug Safety, David Graham, told Congress that Vioxx may have caused as many as 55,000 deaths. Graham charged his agency with being "incapable of protecting America" against dangerous drugs. By November 2004 the American Medical Association was recommending that all clinical testing be made publicly available, and that a new regulatory body, independent of the FDA, be created to focus on the safety of drugs already approved for use. **Internet Assignment:** (a) Find out what happened to calls for overhaul of the FDA. (b) Fearing his job was at risk, Graham sought help from the whistleblower support organization, the Government Accountability Project. Find out what happened.

5. The regulatory apparatus of our government depends on ethical behavior on the part of corporations. It depends on corporations to generate accurate data for agencies such as the FDA, the FAA, and the EPA to use in analyzing safety risks. The government's resources are limited; it cannot perform all the necessary tests itself, but must rely on companies to do their

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own tests, and to share all relevant results—particularly when those results point to safety problems. Business decisions to hold back adverse information from regulators can be both fatal and expensive. Consider the Bridgestone/Ford debacle of 2000. In the 1970s, the National Highway Traffic Safety Administration (NHTSA) collected safety data directly from a network of repair shops, but after the budget cuts of the 1980s, this agency began relying on data generated by industry. NHTSA also made reports of foreign car recalls voluntary. In 1999, both Bridgestone and Ford knew the Wilderness tire/Ford Explorer combo was dangerous; there had been dozens of tread separations and SUV rollover deaths abroad, particularly in hot climates. The two companies planned a recall in Saudi Arabia, but then made a joint decision not to alert NHTSA, fearing this would lead to a recall in the United States. By late 2000, after SUV rollovers caused more than 100 fatalities in the United States, Bridgestone was forced to recall more than 6 million tires, and both companies faced countless lawsuits.

The dissent in *Pierce* mentions the need to protect "professional autonomy." What does this phrase mean? What connection might professional autonomy have with the U.S. safety regulatory scheme?

6. In 1986, responding to the *Pierce* decision of its supreme court, the New Jersey legislature adopted *The Conscientious Employee Protection Act,*[18] shielding from retaliation employees who object to, or refuse to participate in, "any activity, policy or practice which the employee reasonably believes to be incompatible with a clear mandate of public policy concerning the public health, safety or welfare." What would have been the likely outcome had Dr. Pierce sued under this new law? **Internet Assignment:** By 2000, every state in the United States had adopted whistleblower protection statutes of some type. Locate one such law from your home state. Under what circumstances are whistleblowers protected? Are private sector as well as government employees covered? Does coverage under the statute exclude the possibility of suing in tort?

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Statistics on Whistleblowers

> *Physical courage is remarkably widespread in [the U.S.] population. . . . Moral and intellectual courage are not in nearly so flourishing a state, even though the risks they entail—financial or professional disadvantage, ridicule, ostracism—are comparatively minor. . . . These forms of courage suffer from the disadvantage of requiring new definitions continually, which must be generated out of individual perception and judgment. They threaten or violate loyalty, group identity. . . They are, intrinsically, outside the range of consensus.*
>
> — Marilynne Robinson

Who are these people who blow the whistle? Are they informers, troublemakers, tattletales, or are they, as one sociologist has described them, "ethical resisters,"[19] brave dissenters, the watchdogs of the general good? Do they deserve to be ostracized or treated like heroes?

The next reading describes a survey of whistleblowers.

18 N.J.S.A. 34:19-1 et. seq.

19 Myron Peretz and Penina Migdal Glazer, *The Whistleblowers* (New York: Basic Books, 1989).

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Survey of Whistleblowers Finds Retaliation but Few Regrets

C. H. Farnsworth[20]

Workers who reveal waste, fraud and abuse can expect retaliation, financial loss and high emotional and physical stress, according to a survey by two Maryland researchers.

Donald R. Soeken, a psychiatric social worker, and his wife, Karen L. Soeken, a statistician, found that whistleblowers win little more than increased self-respect. But they also found, in the first systematic effort to determine what actually happens to whistleblowers, that most of them would do it again.

A whistleblower who worked in a nuclear power plant wrote: "This has turned out to be the most frightening thing I have ever done. But it has been the most satisfying. I think I did the right thing, and I have caused some changes to be made in the plant."

Their study shatters a perception of whistleblowers as misfits. The average whistleblower in the survey was a 47-year-old family man who was employed seven years before exposing wrongdoing. Most were driven by conscience.

As a group, the whistleblowers were moderately religious. They tended to assume that the best could be achieved by following universal moral codes, which guided their judgments.

After exposing misdeeds, all those in the private sector reported they were dismissed. Because of Civil Service administrative appeals, it is more difficult to dismiss Government workers, but 51 percent of these whistleblowers reported they were no longer with the same agency.

One out of every five of those in the survey reported they were without a job, and 25 percent mentioned increased financial burdens on the family as the most negative result of their action. 17% lost their homes.

Fifty-four percent of the whistleblowers said they were harassed by peers at work. Mrs. Soeken said, "We got replies like 'People made fun of me,' or 'People who I thought were my best friends stopped associating with me. . . .'"

A Government worker said, "don't do it unless you're willing to spend many years, ruin your career and sacrifice your personal life." 15% view their subsequent divorce a result of their whistleblowing activity. 10% report having attempted suicide. Others admit having considered it.

But an engineer in private industry replied more positively: "Do what is right. Lost income can be replaced. Lost self-esteem is more difficult to retrieve."

Another Federal employee confided, "Finding honesty within myself was more powerful than I expected."

The whistleblowing experience took a high toll in physical and emotional health, the survey showed. 80% reported physical deterioration, with loss of sleep and added weight as the most common symptoms. 86% reported negative emotional consequences, including feelings of depression, powerlessness, isolation, anxiety and anger.

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Montana's Statute on Wrongful Discharge

In 1987, Montana passed the following law, the first in the nation to override employment-at-will.

20 *New York Times,* February 21, 1988.

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Wrongful Discharge from Employment Act[21]

Purpose

This part sets forth certain rights and remedies with respect to wrongful discharge. Except as limited in this part, employment having no specified term may be terminated at the will of either the employer or the employee on notice to the other for any reason considered sufficient by the terminating party.

Definitions

In this part, the following definitions apply:

(2) "Discharge" includes a constructive discharge . . . and any other termination of employment, including resignation, elimination of the job, layoff for lack of work, failure to recall or rehire, and any other cutback in the number of employees for a legitimate business reason.

(3) "Employee" means a person who works for another for hire. The term does not include a person who is an independent contractor. . . .

(5) "Good cause" means reasonable job-related grounds for dismissal based on a failure to satisfactorily perform job duties, disruption of the employer's operation, or other legitimate business reason. The legal use of a lawful product by an individual off the employer's premises during nonworking hours is not a legitimate business reason. . . .

(7) "Public policy" means a policy in effect at the time of the discharge concerning the public health, safety, or welfare established by constitutional provision, statute, or administrative rule.

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Elements of Wrongful Discharge

A discharge is wrongful only if:

(1) it was in retaliation for the employee's refusal to violate public policy or for reporting a violation of public policy;

(2) the discharge was not for good cause and the employee had completed the employer's probationary period of employment; or

(3) the employer violated the express provisions of its own written personnel policy.

Remedies

(1) If an employer has committed a wrongful discharge, the employee may be awarded lost wages and fringe benefits for a period not to exceed 4 years from the date of discharge, together with interest thereon. . . .

(2) The employee may recover punitive damages otherwise allowed by law if it is established by clear and convincing evidence that the employer engaged in actual fraud or actual malice in the discharge of the employee [for refusing to violate public policy or for reporting a violation of public policy.]

Exemptions

This part does not apply to a discharge:

(1) that is subject to any other state or federal statute that provides a procedure or remedy for contesting the dispute. Such statutes include those that prohibit discharge for filing complaints, charges, or claims with administrative bodies or that prohibit unlawful discrimination

21 39 *Montana Code Annotated* Chapter 2, Part 9. Puerto Rico has been the only other U.S. jurisdiction that has passed equivalent legislation.

based on race, national origin, sex, age, handicap, creed, religion, political belief, color, marital status, and other similar grounds.

(2) of an employee covered by a written collective bargaining agreement or a written contract of employment for a specific term.

Preemption of Common-Law Remedies

Except as provided in this part, no claim for discharge may arise from tort or express or implied contract.

• QUESTIONS •

1. How would the *Milton* case have been decided had this law been in effect in Maryland? How would Dr. Pierce have fared under it?
2. What parts of this law seem to benefit employees? Employers?
3. The state laws protecting whistleblowers vary enormously, but none of them protect whistleblowers who turn to the media first. Why do you think that is so? Does that seem like sound policy to you? Does it encourage or discourage ethical behavior?

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Global View: U.S., U.K., Japan

The United States stands virtually alone in the world, in that more than 200 million of its workers can be fired almost at the unfettered discretion of their employers. Nearly all of the developed nations who are our global competitors have laws protecting against wrongful discharge, establishing special tribunals where such claims can be adjudicated. Protective statutes exist in more than 60 countries, such as Japan, Canada, and the European Community.

The International Labor Organization of the United Nations (ILO) has a mandate to identify global labor problems, and to come up with standards—called "conventions"—for addressing them. Although compliance with its standards is voluntary, they do carry moral authority. A convention of the ILO calls upon all its members to adopt laws that would protect against wrongful discharge. The representative from the United States was the only one to vote against that convention.

While there is no general whistlebower legislation at the federal level in the United States, other nations have acted to protect whistleblowers. The United Kingdom adopted a law in 1998 after several widely publicized scandals. One involved the drowning of four children because of inadequate safety equipment and training at a recreational facility. Management had fired an employee who had complained about the conditions there. In a second incident, 18,000 elderly investors lost their savings when an investment firm collapsed. The U.K. legislation, the *Public Interest Disclosure Law,* protects employees with a reasonable, good faith belief that an illegality, a "danger to health or safety," or "damage to the environment" is occurring. Three types of disclosures are protected: internal (to the employer), regulatory (to the government) and wider (to the media or police). An employee must have escalating certainty about wrongdoing to be protected for these ascending levels of whistleblowing.

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In Japan too, legislation was prompted by scandal, by widespread disillusionment with both corporate and governmental abuse of power. In 1999 the world's second worst nuclear accident happened when workers at a Japanese uranium processing plant mixed nuclear fuel in buckets, an extremely unsafe practice mandated by the facility's operating manual. In 2000 Japan's most famous dairy allowed unhygienic conditions to fester, and thousands were food poisoned. In 2002, during the mad cow scare, Nippon Meat Packers mislabeled product to get government subsidies. And in 2003 the public learned that, for 30 years, while it disowned responsibility for fatal car accidents, Mitsubishi was hiding evidence of safety defects. In each instance, insiders who complained were ostracized. Japanese culture values group stability and harmony ("wa") very highly, and whistle-blowing there is subversive in a deep way. One proverb says: "The nail that sticks up gets hammered." (When salesman Hiroaki Kushioka discovered evidence that his company was participating in price-fixing, he told his bosses, and was told to keep quiet. He then went to the regulators, and the media. Once the controversy died down, the company transferred Kushioka to a remote subsidiary, where his office was a room without a working telephone. For 27 years, he was given only humiliating tasks, like snow shoveling and weeding, and not a single promotion.) But cascading scandals finally led the Japanese Diet to act. As of June 2006, employees will be protected if they report illegal behavior to their superiors or to the government. They are not protected, however, when the behavior they report is unethical yet legal, or when they report to the media or to consumer groups. And while whistleblowers can sue to redress retaliation, the new law does not mete out fines for corporate wrongdoing. Critics worry that Japan has passed toothless legislation.

If you could write model legislation for all American employees, what would it look like? Would you make any change in employment-at-will? Would you provide protection for whistleblowers?

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THE QUESTION OF LOYALTY

Mere blind obedience to every wish of the person who is the object of loyalty is not loyalty; it is a perversion of loyalty. There is no moral value to it, since it is not something that is morally due. A loyal Nazi is a contradiction in terms.

— Edwards, ed., *Encyclopedia of Philosophy,* p. 98

Tell tale tit
Your tongue shall be slit
And all the dogs in town
Shall have a little bit.

— Children's rhyme

Ms. Watkins is no whistleblower in the conventional sense. She was and is a loyal employee.

— Rep. James Greenwood (R., Pa.) Chairman of House Energy and Commerce Committee investigating the collapse of Enron Corp.

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At the crux of the whistleblower's decision is the question of loyalty, and of divided loyalties. An employee like Dr. Pierce who blows the whistle experiences opposite pulls—allegiance to the employer and allegiance to a professional code of values. The same might be said of Sherron Watkins, the most well-known whistleblower associated with Enron Corporation.

Although Ms. Watkins was not the first or the only person inside Enron who raised concerns about shady accounting practices employed by the firm's CFO, she was the one in the spotlight at the time Enron collapsed. In the following article, law professor Leonard Baynes takes up the example of Sherron Watkins as a means of discussing the difficult position of the corporate insider who chooses to blow the whistle. He goes on to ask whether the Sarbanes-Oxley Act, the new federal law designed to prevent future Enrons, adequately addresses the quandary of the corporate whistleblower.

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JUST PUCKER AND BLOW: AN ANALYSIS OF CORPORATE WHISTLEBLOWERS

Leonard M. Baynes[22]

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You know how to whistle, don't you, Steve? You just put your lips together—and blow.

— Lauren Bacall to Humphrey Bogart in *To Have and To Have Not*

Ms. Watkins was a Vice-President at Enron Corp. She earned a master's degree in professional accounting from the University of Texas at Austin. In 1982, she began her career as an auditor with the accounting firm Arthur Andersen, spending eight years at its Houston and New York offices. In 1983, she became a certified public accountant. Enron Vice-President Andrew Fastow hired Ms. Watkins to manage Enron's partnership with the California Public Employee Retirement System. From June to August 2001, Ms. Watkins worked directly for Mr. Fastow. During this time, Ms. Watkins learned that Enron was engaging in accounting improprieties with certain affiliated entities. She believed that Enron was using its own stock to generate gains and losses on its income statement. [She] . . . failed to receive satisfactory explanations regarding these accounting transactions from Enron executives. . . . [S]he was troubled by the accounting practices but was uncomfortable reporting them to either Mr. Fastow or former Enron President Jeff Skilling, fearing termination. . . . On August 15, 2001, Ms. Watkins sent to Kenneth Lay, the CEO of Enron, a seven-page anonymous letter. In the letter, Ms. Watkins asked, "Has Enron become a risky place to work?" She also more specifically described the accounting improprieties and stated that "to the layman on the street [it will look like] we are hiding losses in a related company and will compensate that company with Enron stock in the future." She shared her prescient fears that Enron might "implode in a wave of accounting scandals." On August 22, 2001, Ms. Watkins met with Mr. Lay and outlined her concerns about the accounting improprieties, and requested a transfer from working for Mr. Fastow. In late August she was reassigned to the human resources group. Ms. Watkins reported that Mr. Lay assured her that he would investigate the irregularities. Ms. Watkins never reported her concerns to the SEC, the Department of Treasury, or any other governmental official. . . .

22 76 *St. John's L. Rev.* 875, Fall 2002.

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Ms. Watkins is the prototypical whistleblower because she had knowledge of damaging information and she disclosed it to her supervisor's supervisor. At the same time, she is very atypical for several reasons. First, as an accountant, she had the expertise to know that her corporation was possibly breaking the law and defrauding the public. Second, her disclosure in and of itself to the president of the corporation did not lead to the type of investigation that was necessary to stop any wrongdoing. Her actions did not cause the immediate collapse of the Enron financial giant. Third, even though she "ratted" out her boss . . . her disclosure did not compromise her job security. In fact, Ms. Watkins has received a lot of positive press from her actions. . . . Ms. Watkins was even named Time magazine's "Person of the Week. . . ." A movie deal also is reportedly in the works that will paint Ms. Watkins as a "feminist icon," like Erin Brockovich. . . .

[Baynes next points to the dangerous tight-rope a corporate whistleblower typically walks, who may be "damned if she does 'just pucker and blow,' and damned if she does not." He explains that corporate executives must be responsive to two common law obligations. First, they are under a "duty of loyalty:"]

They must act in good faith and in a manner that they reasonably believe will be in the best interests of the corporation, including safeguarding corporate information. . . . The nature of the corporation requires it to rely on the officers and managers to run the day-to-day business. These employees have access to a very precious commodity, that is, vital and privileged corporate information. In the more mundane duty of loyalty cases, the senior executive has access to important corporate information dealing with customer lists, customer preferences, customer pricing, new opportunities, and secret formulas.

[T]hese principles still apply in the whistleblowing context. For example, the whistleblower may convert corporate proprietary information by taking corporate records and sharing them with the authorities. The whistleblower could disclose information that, at worst, could lead to civil or criminal liabilities for the corporation and its other senior officers and directors. At best, certain disclosures could lead to significant embarrassment or humiliation. In either case, deciding how to make such disclosures would usually be a decision of the board of directors and senior managers of the corporation. For example, if the disclosure might give rise to criminal or civil liability, the corporation under the best of circumstances would want to vest its decision with its attorneys in an effort to minimize its potential liability and maximize profits. If the whistleblower discloses the information, she may make it impossible for the corporation and other senior executives to obtain a good deal from prosecutors. If the information disclosed is not rooted in civil or criminal misconduct, but nevertheless is scandalous, the corporation may want to refrain from disclosing such information. The whistleblower may cause a great deal of public relations harm by disclosing such information. . . . [S]enior executives know where the corporation may be most vulnerable . . . [and] are in a position to inflict harm on the corporation in a way that strangers cannot.

[Baynes then outlines the other pole of responsibility for corporate executives.]

Corporate officers and senior executives have a duty of care to the corporation. They have an obligation to perform their duties with the care that a person in a like position would reasonably exercise under similar circumstances. This duty has been analogized to the diligence, care, and skill that ordinarily prudent individuals would exercise in the management of their affairs. . . .

In the case of whistleblowing, tension between the duty of loyalty and duty of care exists. The senior executive is required to disclose her objections to certain actions that she believes are illegal. But how is she supposed to do that? As a non-director officer, she could disclose her objections to her supervisor or her supervisor's supervisor like Sherron Watkins did at Enron. This objection may take the form of a "cover your ass" memo. But will this really stop wrongdoing? In some cases, such a memo may be insufficient to stop the wrongdoing, and the senior executive may have an obligation to report the matter to the authorities. She may, however, be in a bind because her contractual obligations and her duty of loyalty responsibilities may limit the type of information that she could give to the authorities. In addition, unless someone has real inside information allowing them to actually observe the wrongdoing and has the expertise to know that the wrongdoing is illegal, what safe harbor exists to protect the senior executive from mistakenly reporting wrongdoing?

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[In 2002 the Sarbanes-Oxley Act was passed, in response to the wave of corporate scandals that began with Enron. As Baynes explains, it "was designed to promote investor confidence by ensuring that the public receives more information about possible corporate fraud. Such disclosures would ensure that the markets have perfect information so that investors could make informed investment choices."]

The Sarbanes-Oxley Act prohibits any public company from discriminating against any employee who lawfully provides information or otherwise assists in an investigation of conduct that the employee "reasonably believes" constitutes a violation of the federal securities laws. This provision was designed from the lessons learned from Sherron Watkins's testimony. As Senator Patrick Leahy stated, "'We learned from Sherron Watkins of Enron that these corporate insiders are the key witnesses that need to be encouraged to report fraud and help prove it in court.'" The legislation protects an employee from retaliation by an employer for testifying before Congress or a federal regulatory agency, or giving evidence to law enforcement of possible securities fraud violations. To secure this protection, the employee must have assisted in an investigation, which was conducted by Congress, a federal agency, the employee's supervisor, or anyone else authorized by the employer to conduct an investigation. . . .

[Baynes now asks whether the anti-retaliation provision of the new law adequately addresses the dilemma of the corporate whistleblower, caught in the "vortex" of the duty of loyalty and the duty of care.]

Undoubtedly, the Sarbanes-Oxley Act provides an extra level of protection for employees. Despite this . . . we must be cognizant that federal whistleblowers have low success rates in their suits before government agencies. The Whistleblowers Survival Guide reports that "the rate of success for winning a reprisal lawsuit . . . for federal whistleblower laws has risen to between 25 and 33 percent in recent years." Under the Act, the corporate senior executive or employee is likely . . . also [to] have a low rate of success under its whistleblowing provisions. First, the statute only affords protection against retaliations based on securities fraud. Whistleblowing of other kinds of wrongdoing remain unprotected under this Act. In these cases, the whistleblower then must rely on the vagaries of state law, which generally give preference to those allegations dealing with public safety. For example, a senior executive may overhear a high-ranking executive make disparaging remarks about a particular racial group and state that he would never hire or promote members of that group. The corporation employs very few members of this particular group and has none in senior management. The senior executive believes that the corporation is engaged in race discrimination. The senior executive has a fiduciary obligation to hold certain corporate information like employee demographics in confidence but has an obligation to resign or object from his position when confronting corporate wrongdoing. The Act provides protection only for those matters that involve security fraud. If this senior manager discloses, she would have to rely on the protections of the state laws.

Second, low-level employees are also relatively unprotected. They probably are unaware of these new protections. They may feel particularly oppressed by the many layers of management that may exist in some corporations. Some may be unsophisticated and may not know whether certain actions violate the law. Many of the wrongful or illegal activities that they observe may not rise to the level of securities fraud. For example, an employee at McDonald's may notice that large numbers of pre-packaged hamburgers disappear shortly after delivery. The disappearance may be the result of conversion by the store manager. The McDonald's employee might be in the best position to ascertain whether this wrongdoing is occurring, but she is unprotected by the Sarbanes-Oxley Act because this conversion does not involve securities fraud. . . . In addition, many of these employees rely very heavily on their paychecks; a high turnover rate exists in these jobs. Students and those re-entering the workforce hold many of these jobs. These individuals may be particularly reluctant to "rock the boat" and report wrongdoing unless they are guaranteed that their job is protected. The Act does nothing to address this population of whistleblowers.

Third, for both senior executives and low-level employees, the Sarbanes-Oxley Act gives little guidance as to the circumstances under which an employee is to disclose allegations of wrongdoing to her supervisor as opposed to law enforcement authorities. Senior executives also have an obligation

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to use "reasonable efforts" to disclose to the principal information which is "relevant to affairs entrusted to [the agent]" and which the principal would desire to have. . . . In some instances, however, the whistleblowing employee who reports wrongdoing to her supervisor might not be doing enough to stem the wrongdoing behavior. For instance, once she has made the report, the wrongdoing supervisor might exclude the employee from access to information that would allow her to continue to observe the wrongful behavior. In those cases, the reporting employee may have breached her duty of care to the corporation by using insufficient actions to stop the wrongdoing. . . . Conversely, if the whistleblowing employee reports the evidence of wrongdoing immediately to law enforcement authorities, she may be violating her duty of loyalty to the corporation. . . . She has an obligation to protect certain proprietary and confidential corporate information. Also by going to the law enforcement authorities right away, she may be depriving the corporation of the opportunity to resolve the matter or, in the case of wrongdoing, get the best deal for the corporation. In addition, the employee who jumps the gun and goes to law enforcement authorities may be putting herself in a difficult political situation at her corporation. Even though the terms of her position and employment may remain the same, she will always, to her detriment, be remembered for making that report.

Fourth, the Sarbanes-Oxley Act gives no guidance concerning whether the whistleblowing employee should disclose the information to her direct supervisor or her supervisor's supervisor. Who is the principal of senior executives? Is it the corporation? Is it the board of directors? Is it the senior executive's boss?

[Baynes writes that the same kinds of problems raised above arise here. If the report goes to a direct supervisor, the employee may not be doing enough to stop the behavior. But by going over his head, she prevents her direct supervisor from fixing the problem himself, and risks being "perceived as a 'rat fink,'" something Baynes euphemistically notes "may be a career-limiting move."

Fifth, the legislative history of the Sarbanes-Oxley Act states that the employee's actions have to be reasonable in making reports. . . . Most cases may not be as clear-cut as the one involving Sherron Watkins. Because she was an accountant, she had a very good idea that Enron's accounting policies were illegal. For most other whistleblowers, they may have only a slight inkling that something might be amiss. In those circumstances, what are they supposed to do? Depending on the nature of the corporation, they may have an obligation to investigate further. We then may require the senior executives of major corporations to be "Nancy Drew, Girl Detective." With downsizing, . . . many of these employees already have many additional responsibilities. If, however, they fail to properly investigate their suspicions, they may violate their duty of care to the corporation. [A]lthough Senator Leahy stated that the Act protects whistleblowers who report and disclose their reasonable suspicions, the statutory language fails to explicitly provide such protection. Whistleblowers who report and disclose their reasonable suspicions are in a tough spot if their allegations turn out to be unfounded. . . .

Sixth, the Sarbanes-Oxley Act prohibits a corporation from "discharg[ing], demot[ing], suspend[ing], threaten[ing], harass[ing], or in any other manner discriminat[ing] against an employee in the terms and conditions of employment" because she blew the whistle. Senator Leahy conceded, however, that "most corporate employers, with help from their lawyers, know exactly what they can do to a whistleblowing employee under the law." The types of retaliation that can occur include: (1) "attacking the [whistleblower's] motives, credibility, [or] professional competence"; (2) "build[ing] a damaging record against [the whistleblower]"; (3) threatening the employee with "reprisals for whistleblowing"; (4) "reassign[ing]" the employee to an isolated work location; (5) "publicly humiliat[ing]" the employee; (6) "set [ting] . . . up [the whistleblower] for failure" by putting them in impossible assignments; (7) "prosecut[ing the employee] for unauthorized disclosures [of information]"; (8) "reorganiz[ing]" the company so that the whistleblower's job is eliminated"; and (9) "blacklist[ing]" the whistleblower so she will be unable to work in the industry. Of course some methods on this list would clearly violate the Act. A deft supervisor, however, could "set up" the whistleblowing employee for failure. For instance, the employer may place the whistleblower in a job unsuitable to her skill level to ensure her failure. The employer could then document the employee's poor performance. The Act provides protections for whistleblowing

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employees except in cases where valid business reasons exist for their termination like inferior work performance. In addition, even if the employer refrains from discriminating against the whistleblowing employee in the terms and conditions of her employment, the employer is unlikely to give that employee any opportunities for advancement. By blowing the whistle, she may have "tapped out" her career trajectory. . . . Her future supervisors will probably always worry that she is not a "team player" who may go over their heads when she suspects they are doing something wrong.

• QUESTIONS •

1. Describe the conflict faced by corporate insiders who discover unethical or illegal activities within their organizations.

2. Would the SOX law have protected Dr. Donn Milton? Dr. Grace Pierce? What kinds of corporate wrongdoing might a senior executive discover that would not be covered by SOX?

3. Baynes identifies these weaknesses in the SOX law:

"(1) non-securities fraud matters are not covered;
(2) low-level employees may not be aware of the protections;
(3) no guidance is given as to when to report wrongdoing to outside authorities or to a supervisor;
(4) no guidance is given as to when the whistleblower should go over his or her supervisor's head to senior management; and
(5) no protection is given to undercover retaliations that do not quite manifest themselves as a "discharge, demotion, suspension, threat, or other manner of discrimination."

Working with a group of classmates, tackle each of these issues. How would you amend the law to respond to them? Might some of these concerns be more effectively addressed by changes in corporate culture? If so, what changes would your group recommend?

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4. In 1991 law professor Anita Hill gave congressional testimony implicating then Supreme Court nominee Clarence Thomas in sexually inappropriate behavior towards her when he was her supervisor at the EEOC. In 2002 she published an editorial in the *New York Times* noting that many prominent whistleblowers happened to be women. She suggested that women who have had the opportunity to rise to power within corporate or governmental organizations are more likely to blow the whistle, calling them insiders with "outsider values."[23] At the close of 2002, three women whistleblowers made the cover of *Time Magazine,* touted as "Persons of the Year:" Sherron Watkins was joined by Cynthia Cooper, who uncovered accounting improprieties at Worldcom, and Colleen Rowley, the FBI employee who pleaded unsuccessfully for the agency to investigate Zacarias Moussaoui, a co-conspirator in the attacks of September 11th. What do you think of the claim that women insiders are likely to have "outsider values"? What does that mean? How might it relate to a tendency to blow the whistle?

5. Sherron Watkins was lucky, in that she was a hero in the eyes of the public, but as Baynes notes elsewhere in his article, most whistleblowers do not receive accolades:

> *In Sophocles's Antigone, a messenger tells Creon that someone has given proper funeral rites to Polyneices' body and remarks "no[one] delights in the bearer of bad*

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23 In a July 2002 *Washington Post* article citing Anita Hill's insider/outside thesis, Paul Farhi wrote:

> After years of tortured progress, women sit closer than ever to the inner circle of American corporations and government institutions. Close to it, but not in it. While the International Labor Organization estimated in 1998 that American women held about 43 percent of all managerial positions, a survey two years earlier of Fortune 500 companies indicated that women held only 2.4 percent of the highest management jobs and made up just 1.9 percent of the highest-paid officers and directors. So, a few women have gotten close to the summit—with access to sensitive information, authority over subordinates, a direct line to the boss—but generally aren't themselves at the top. The top remains a male preserve.

news." As evidenced by this ancient Greek play, society has often blamed and disliked the bearer of bad news. Even in our more recent American history, whistleblowers have often been portrayed as liars, sometimes vile or untrustworthy . . .

Why do you think society tends to react against dissenters?

6. **Internet Assignment:** Founded in 1977, the Government Accountability Project promotes "government and corporate accountability through advancing occupational free speech and ethical conduct, defending whistleblowers, and empowering citizen activists. What tips do they offer a would-be whistleblower? See http://www.whistleblower.org.

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Ethical Corporate Culture Makes For Loyal Employees

According to a recent study of almost 10,000 business, governmental and non-profit employees from around the world, "people care deeply about the same few things. . . [P]eople everywhere ask: Am I fairly compensated for my work? Am I well suited for my work? Does my employer trust me to do that work?"

Employees were divided into four groups:

TRULY LOYAL (34%): those who work hard and late, "go the extra mile to delight the customer, and recommend the company to their friends as a good place to work."

ACCESSIBLE (8%): employees who are no less loyal to the company in their feelings or actions, but see themselves as possibly moving within two years for unrelated, personal reasons—such as following a spouse or taking on new family obligations.

TRAPPED: (31%): people who want to leave their jobs, but feel that they cannot.

HIGH RISK: (27%): those who are "spending their working hours clicking through Monster.com" and wouldn't recommend their company as a good place to work.

The study reported a connection between ethics and loyalty: "Employees who perceive their employers as ethical are more likely to be proud to be associated with the company. Of the employees who felt they were working for an ethical company, 55% were Truly Loyal. Only 9% of those who questioned their employer's ethics were Truly Loyal."

Researcher Marc Drizin had this advice: "Being an ethical company doesn't really cost money over the long term. What it does cost is cheap compared to the cost of replacing workers revolving through your door. Some U.S. statistics may help us to understand this: On average, it costs $8,000 to $10,000 to replace a manufacturing employee. It costs $15,000 to replace that kid on the front line who sells you hats and jackets. It costs $3,000 just to interview someone before actually hiring or training him or her. And the cost for an IT worker, on average, is astronomical: over 125% of that employee's annual compensation."

Drizin even suggests a pay-off from career-development programs that lead employees to better jobs at other companies: "[B]eing an exporter of talent is not a bad thing. . . . The person who leaves will tell everyone else, 'Man, that was a good place to work. Go apply for my job!' "[24]

24 Katherine J. Sweet, "Employee Loyalty Around the World," *MIT Sloan Management Review,* Vol. 42, No. 2, Winter 2001, p. 16.

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Public Employees and Freedom of Speech

What I was surprised at was the silence, the collective silence by so many people that had to be involved, that had to have seen something or heard something.

— Sgt. Samuel Provance, key witness in government investigation of Abu Ghraib prison abuse

People who work for the government or for any of its branches—such as police, air traffic controllers, and those employed by government-supported institutions like hospitals or schools—are called public employees. For almost 200 years, public employees were thought to have no greater speech rights than those who worked in the private sector. The leading case, which dates back to the nineteenth century, involved a policeman who was fired for publicly criticizing the management of his department. He sued to get his job back, relying on his free speech rights. Judge Oliver Wendell Holmes refused his claim, stating, "The petitioner may have a constitutional right to talk politics, but he has no constitutional right to be a policeman."[25]

Then, in 1968, the Supreme Court re-interpreted the First Amendment of the U.S. Constitution to give public employees limited speech protections. Marvin Pickering, a public school teacher, was fired for publishing a letter in the local paper critical of the Board of Education's allocation of funds to its athletic program. He sued, losing in the lower courts. On appeal, however, the Court ruled in his favor. In *Pickering v. Board of Education,*[26] the Court weighed "the interests of the teacher, as a citizen, in commenting upon matters of public concern" against the "interest of the State, as an employer, in promoting the efficiency of the public services it performs through its employees." On balance, Pickering's free speech interests were greater. In 1983, the Supreme Court re-affirmed and clarified the *Pickering* test as it decided *Connick v. Myers.*[27] Sheila Myers had distributed a questionnaire at her place of employment. The circular inquired not only about internal matters, such as an office transfer policy, but also about matters of legitimate public concern, including pressure put on employees to work on certain political campaigns. Based on its content, form, and context, the *Connick* Court determined that the questionnaire was tinged with just enough public interest to be examined under the *Pickering* test, although a statement limited to internal matters would not be. Myers lost her case, however, since the government demonstrated that her questionnaire interfered with working relationships by causing a "mini-insurrection" that could have disrupted the office. Had her speech been of greater importance to the public, the Court explained, the government may have had a harder case.

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Today, to prevail on a First Amendment claim, a fired public employee must prove that the conduct at issue was constitutionally protected, and that it was a substantial or motivating factor in the termination. The government can still avoid liability by proving that the person would have been fired even in the absence of the protected conduct ("dual motive"), or that the firing was justified because the countervailing government interests are sufficiently strong. The Court also has ruled that the same balancing test applies to independent contractors who claim they lost government contracts in retaliation for exercising their free speech rights.[28]

25 *McAuliffe v. Mayor of New Bedford,* 29 N.E. 517 (1892).

26 391 U.S. 563 (1968).

27 *Connick v. Myers,* 461 U.S. 138 (1983).

28 *Board of County Commissioners, Wabaunsee County, Kansas v. Umbetter,* 116 S.Ct. 2342, 518 U.S. 668 (1996).

Try to apply these legal standards to the following recent current events. If these whistleblowers sued, would they succeed in their free speech claims?

- On February 1, 2003, as it was making its re-entry to land, the Columbia space shuttle burst into flame and broke apart over Texas. All 11 astronauts were killed. Two weeks later, scientists learned that foam tiles had broken away from the spacecraft, striking its left wing. A few NASA engineers strongly believed that images of the resultant damage should be created and analyzed. They met with institutional resistance, a "bureaucratic dead end," and the pictures were never taken. Suppose they had persisted in their requests, gone public when they were denied, and then been fired.[29]
- President Bush signed the Medicare bill on December 8, 2003, praising it as "the greatest advance in health care coverage for America's seniors since the founding of Medicare." While Democrats argued the law benefited drug companies and insurers more than the elderly, Republicans hoped to win votes from seniors with it in the November presidential election. In June 2003, as the bill was being considered by Congress, the Bush administration presented costs estimates for the prescription drug plan portion of the bill at $400 billion. However Richard Foster, the Medicare system's chief actuary, estimated those costs much higher—at $500–$600 billion. Foster was threatened with dismissal if he revealed this to Congress.
- In 2004, Richard Clarke, who had been in charge of counterterrorism under President Bush, published a book titled *Against All Enemies,* and went public with his opinion that the president had "done a terrible job in the war against terrorism." The Bush administration responded, arguing Clarke was both "out of the loop" and more interested in book sales than in truth. Suppose the Bush administration took further retaliatory steps against Clarke.
- In May 2004, a key witness in the military investigation into prisoner mistreatment at Abu Ghraib, Sgt. Samuel Provance, 30, told ABC News that dozens of soldiers—in addition to the seven military police reservists who have been charged—were involved in the abuse at the prison, and he said there is an effort under way in the Army to hide it. Provance said, "There's definitely a cover-up. People are either telling themselves or being told to be quiet." He spoke out in spite of orders from his commanders not to, was stripped of his security clearance, transferred to a different platoon, and officially "flagged," meaning he will never be promoted or receive honors within the military. In addition, Provance was told he might face prosecution because his comments were "not in the public interest."

CORPORATE GOVERNANCE AND THE GATEKEEPERS

At the heart of this chapter is the question of accountability. How might a large organization—business or government—police itself? Can we identify the forces that prevent complex organizations from effectively auditing themselves? Can we understand why the mechanisms that are supposed to monitor and punish wrongdoing are often ineffective? From there, can we imagine how to reduce the need for whistleblowing?

The Enron Story

> *As a partner in the communities in which we operate, Enron believes it has a responsibility to conduct itself according to certain basic principles. . . .*
>
> *Respect: We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment. Ruthlessness, callousness and arrogance don't belong here.*

29 James Glanz and John Schwartz, "Dogged Engineer's Effort to Assess Shuttle Damage," *New York Times,* 2003.

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Integrity: We work with customers and prospects openly, honestly and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we won't do it.

Communication: We have an obligation to communicate. Here, we take the time to talk with one another . . . and to listen. We believe that information is meant to move and that information moves people.

— Enron's statement of Vision & Values

The business community tends to look at these things in terms of what can we get away with, rather than what's right. Optics has replaced ethics.

— Arthur Levitt, former SEC chairman, commenting on Enron's collapse

Shortly after the collapse of Enron and as the Worldcom scandal was breaking, securities law scholar John C. Coffee, Jr. analyzed the key role played by corporate watchdogs such as auditors and securities analysts in these events. As Coffee views it, their failure to function effectively was more telling than the failure of the board of directors. It would be a mistake to expect insights from a close reading of the behavior of Enron's board, Coffee writes, since Enron itself was "maddeningly unique:"

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> *Other public corporations simply have not authorized their chief financial officer to run an independent entity that enters into billions of dollars of risky and volatile trading transactions with them; nor have they allowed their senior officers to profit from such self-dealing transactions without broad supervision or even comprehension of the profits involved. . . . Precisely for this reason, the passive performance of Enron's board of directors cannot fairly be extrapolated and applied as an assessment of all boards generally. . . . Enron is an anecdote, an isolated data point that cannot yet fairly be deemed to amount to a trend.*

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Below he explores why the guardians of objectivity—paid whistleblowers, in a sense—did not do their jobs.

UNDERSTANDING ENRON: "IT'S ABOUT THE GATEKEEPERS, STUPID"

John C. Coffee, Jr.[30]

. . . Behind [Enron] is the market's discovery that it cannot rely upon the professional gatekeepers—auditors, analysts, and others—whom the market has long trusted to filter, verify and assess complicated financial information. Properly understood, Enron is a demonstration of gatekeeper failure, and the question it most sharply poses is how this failure should be rectified.

30 57 *Bus. Law* 1403, August 2002. Coffee's title is a play on a phrase that was commonly heard as Bill Clinton was campaigning for president: "It's about the economy, stupid!"

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Although the term "gatekeeper" is commonly used, here it requires special definition. Inherently, gatekeepers are reputational intermediaries who provide verification and certification services to investors. These services can consist of verifying a company's financial statements (as the independent auditor does), evaluating the creditworthiness of the company (as the debt rating agency does), assessing the company's business and financial prospects vis-a-vis its rivals (as the securities analyst does), or appraising the fairness of a specific transaction (as the investment banker does in delivering a fairness opinion). . . .

Characteristically, the professional gatekeeper essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction. This duplication is necessary because the market recognizes that the gatekeeper has a lesser incentive to lie than does its client and thus regards the gatekeeper's assurance or evaluation as more credible. To be sure, the gatekeeper as watchdog is typically paid by the party that it is to watch, but its relative credibility stems from the fact that it is in effect pledging a reputational capital that it has built up over many years of performing similar services for numerous clients. In theory, such reputational capital would not be sacrificed for a single client and a modest fee. Here, as elsewhere, however, logic and experience can conflict. Despite the clear logic of the gatekeeper rationale, experience over the 1990s suggests that professional gatekeepers do acquiesce in managerial fraud. . . .

[Coffee goes on to cite statistics demonstrating the extent of gatekeeper failure.]

[T]he number of earnings restatements by publicly held corporations averaged 49 per year from 1990 to 1997, then increased to 91 in 1998, and finally skyrocketed to 150 and 156, respectively, in 1999 and 2000. . . .

As late as October 2001, sixteen out of seventeen securities analysts covering Enron maintained "buy" or "strong buy" recommendations on its stock right up until virtually the moment of its bankruptcy filing. . . .

According to a study by Thomson Financial, the ratio of "buy" to "sell" recommendations increased from 6 to 1 in 1991 to 100 to 1 by 2000.

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Explaining Gatekeeper Failure

None of the watchdogs that should have detected Enron's collapse—auditors, analysts or debt rating agencies—did so before the penultimate moment. This is the true common denominator in the Enron debacle: the collective failure of the gatekeepers. Why did the watchdogs not bark in the night when it now appears in hindsight that a massive fraud took place? Here, two quite different, although complementary, stories can be told. The first will be called the "general deterrence" story, and the second, the "bubble" story. The first is essentially economic in its premises, and the second, psychological.

The Deterrence Explanation: The Underdeterred Gatekeeper

[Here Coffee explains that auditors had lower incentives to resist pressure from clients to use aggressive accounting techniques, because, throughout the 1990s as those demands increased, the risks of legal liability decreased. He mentions several specific changes in relevant law, including a 1994 Supreme Court decision which eliminated liability for "aiding and abetting" securities fraud, and a federal law passed in 1995 that made it more difficult for plaintiffs to succeed in securities fraud claims. As the legal environment became considerably more permissive, particularly for auditor defendants, the benefits of caving in to management pressures became greater.]

. . . [T]he Big Five learned during the 1990s how to cross-sell consulting services and to treat the auditing function principally as a portal of entry into a lucrative client. Prior to the mid-1990s, the provision of consulting services to audit clients was infrequent and insubstantial in the aggregate. Yet, according to one recent survey, the typical large public corporation now pays its auditor for consulting services three times what it pays the same auditor for auditing services. Not only did auditing firms see more profit potential in consulting than in auditing, but they began during the

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1990s to compete based on a strategy of "low balling" under which auditing services were offered at rates that were marginal to arguably below cost. The rationale for such a strategy was that the auditing function was essentially a loss leader by which more lucrative services could be marketed.

Appealing as this argument may seem that the provision of consulting services eroded auditor independence, it is subject to at least one important rebuttal. Those who defend the propriety of consulting services by auditors respond that the growth of consulting services made little real difference, because the audit firm is already conflicted by the fact that the client pays its fees. More importantly, the audit partner of a major client, such as Enron, is particularly conflicted by the fact that such partner has virtually a "one-client" practice. Should the partner lose that client for any reason, the partner will likely need to find employment elsewhere. In short, both critics and defenders of the status quo tend to agree that the audit partner is already inevitably compromised by the desire to hold the client. From this premise, a prophylactic rule prohibiting the firm's involvement in consulting would seemingly achieve little.

While true in part, this analysis misses a key point: namely, how difficult it is for the client to fire the auditor in the real world. Because of this difficulty, the unintended consequence of combining consulting services with auditing services in one firm is that the union of the two enables the client to more effectively threaten the auditing firm in a "low visibility" way. To illustrate this point, let us suppose, for example, that a client becomes dissatisfied with an auditor who refuses to endorse the aggressive accounting policy favored by its management. Today, the client cannot easily fire the auditor. Firing the auditor is a costly step, inviting potential public embarrassment, public disclosure of the reasons for the auditor's dismissal or resignation, and potential SEC intervention. If, however, the auditor also becomes a consultant to the client, the client can then easily terminate the auditor as a consultant, or reduce its use of the firm's consulting services, in retaliation for the auditor's intransigence. This low visibility response requires no disclosure, invites no SEC oversight, and yet disciplines the audit firm so that it would possibly be motivated to replace the intransigent audit partner. In effect, the client can both bribe (or coerce) the auditor in its core professional role by raising (or reducing) its use of consulting services.

Of course, this argument that the client can discipline and threaten the auditor/consultant in ways that it could not discipline the simple auditor is based more on logic than actual case histories. But it does fit the available data. A recent study by academic accounting experts, based on proxy statements filed during the first half of 2001, finds that those firms that purchased more non-audit services from their auditor (as a percentage of the total fee paid to the audit firm) were more likely to fit the profile of a firm engaging in earnings management.

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The Irrational Market Story

Alternatively, Enron's and Arthur Andersen's downfalls can be seen as consequences of a classic bubble that overtook the equity markets in the late 1990s and produced a market euphoria in which gatekeepers became temporarily irrelevant. Indeed, in an atmosphere of euphoria in which stock prices ascend endlessly and exponentially, gatekeepers are largely a nuisance to management, which does not need them to attract investors. Gatekeepers are necessary only when investors are cautious and skeptical. . . . Arguably, auditors were used [in the 1990s] only because SEC rules mandated their use or because no individual firm wished to call attention to itself by becoming the first to dispense with them. [T]he rational auditor's best competitive strategy, at least for the short term, was to become as acquiescent and low cost as possible.

For the securities analyst, a market bubble presented an even more serious problem. It is simply dangerous to be sane in an insane world. The securities analyst who prudently predicted reasonable growth and stock appreciation was quickly left in the dust by the investment guru who prophecized a new investment paradigm in which revenues and costs were less important than the number of "hits" on a Web site. Moreover, as the initial public offering (IPO) market soared in the 1990s, securities analysts became celebrities and valuable assets to their firms; indeed, they became the principal means by which investment banks competed for IPO clients, as the underwriter

with the "star" analyst could produce the biggest first day stock price spike. But as their salaries thus soared, analyst compensation came increasingly from the investment banking side of their firms. Hence, just as in the case of the auditor, the analyst's economic position became increasingly dependent on favoring the interests of persons outside their profession (i.e., consultants in the case of the auditor and investment bankers in the case of the analyst) who had little reason to respect or observe the standards or professional culture within the gatekeeper's profession.

The common denominator linking these examples is that, as auditors increasingly sought consulting income and as analysts increasingly competed to maximize investment banking revenues, the gatekeepers' need to preserve their reputational capital for the long run slackened. . . .

Toward Synthesis

These explanations still do not fully explain why reputational capital built up over decades might be sacrificed or, more accurately, liquidated once legal risks decline and/or a bubble develops. Here, additional factors need to be considered.

The Increased Incentive for Short-Term Stock Price Maximization

The pressure on gatekeepers to acquiesce in earnings management was not constant over time, but rather grew during the 1990s [when] executive compensation shifted from being primarily cash based to being primarily equity based. The clearest measure of this change is the growth in stock options. Over the last decade, stock options rose from five percent of shares outstanding at major U.S. companies to fifteen percent—a three hundred percent increase. The value of these options rose by an even greater percentage and over a dramatically shorter period: from $50 billion in 1997 in the case of the 2000 largest corporations to $162 billion in 2000—an over three hundred percent rise in three years. Stock options create an obvious and potentially perverse incentive to engage in short-run, rather than long-term, stock price maximization because executives can exercise their stock options and sell the underlying shares on the same day. . . . Thus, if executives inflate the stock price of their company through premature revenue recognition or other classic earnings management techniques, they could quickly bail out in the short term by exercising their options and selling, leaving shareholders to bear the cost of the stock decline when the inflated price could not be maintained over subsequent periods. Given these incentives, it becomes rational for corporate executives to use lucrative consulting contracts, or other positive and negative incentives, to induce gatekeepers to engage in conduct that made the executives very rich. The bottom line is then that the growth of stock options placed gatekeepers under greater pressure to acquiesce in short-term oriented financial and accounting strategies.

The Absence of Competition

The Big Five obviously dominated a very concentrated market. Smaller competitors could not expect to develop the international scale or brand names that the Big Five possessed simply by quoting a cheaper price. More importantly, in a market this concentrated, implicit collusion develops easily. Each firm could develop and follow a common competitive strategy in parallel without fear of being undercut by a major competitor. Thus, if each of the Big Five were to prefer a strategy under which it acquiesced to clients at the cost of an occasional litigation loss and some public humiliation, it could more easily observe this policy if it knew that it would not be attacked by a holier-than-thou rival stressing its greater reputation for integrity as a competitive strategy. This approach does not require formal collusion but only the expectation that one's competitors would also be willing to accept litigation losses and occasional public humiliation as a cost of doing business. Put differently, either in a less concentrated market where several dozen firms competed or in a market with low barriers to entry, it would be predictable that some dissident

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firm would seek to market itself as distinctive for its integrity. But in a market of five firms (and only four for the future), this is less likely. . . .

[At this point Coffee notes that the two stories—the deterrence story and the market bubble story—are not necessarily mutually exclusive, but when we begin to think about how to reform the system, it matters which one we think is dominant. If we buy into the bubble story, we may believe that as the bubble bursts the market self-corrects; if we have more faith in the deterrence story, we would want to regulate to make change.]

Conclusion

Reasonable persons can always disagree over what reforms are desirable. But the starting point for an intelligent debate is the recognition that the two major, contemporary crises now facing the securities markets (i.e., the collapse of Enron and the growing controversy over securities analysts, which began with the New York Attorney General's investigation into Merrill Lynch) involve at bottom the same problem—both are crises motivated by the discovery by investors that reputational intermediaries upon whom they relied were conflicted and seemingly sold their interests short. Neither the law nor the market has yet solved either of these closely related problems.

• QUESTIONS •

1. **Internet Assignment:** "Neither the law nor the market" had solved the problem of gatekeeper failure, Coffee wrote at the end of his article. It was published in 2002. Find out what you can about events since then. Have shifting market conditions made a difference in terms of the pressures on gatekeepers to be independent and objective? Has the legal system responded to the Enron/Worldcom scandals in a way that encourages them to do their work more effectively?

2. The accounting profession is self-policed by a professional group, the American Institute of Certified Public Accountants (AICPA). The industry has successfully warded off enhanced government oversight in recent years, as its political campaign contributions burgeoned. Contributing more than $14 million in 2000, for example, the profession is now in the same league as the biggest donors, such as the telecommunications industry and trade unions. **Internet Assignment:** In the wake of the Enron scandal, what is the accounting industry doing to police itself?

3. Coffee states that Enron's board of directors was up against a uniquely bizarre situation. But since Enron/Worldcom, many have a argued for the presence of "independent" directors on corporate boards. **Internet Assignment:** Has there been progress or implementation of this concept?

4. Most large companies have an ethical code, such as Enron's statement of Vision and Values. And we might safely assume that most people who work for large companies are ethical human beings who would not consciously commit illegal or unethical acts. Why, then, do we so often observe a disconnect between corporate ethical codes and business practice?

A 1995 Ethics Resource Center study suggests that ethical codes are overshadowed by other priorities. Of 10,000 employees who responded, 55 percent "never or only occasionally" found their company standards useful in guiding their decisions and actions, reporting corporate underemphasis on ethics as opposed to business goals. While an ethics compliance officer might make an annual attempt to discuss ethics, performance is measured on a quarterly, monthly, or even a daily basis. This disturbing reality is consistent with the findings of Harvard Professor Joseph L. Badaracco, Jr., who interviewed 30 recent graduates of Harvard's MBA program. These young managers were "dubious" about ethics codes and programs, explaining that the values

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contained in them "seemed inconsistent with 'what the company was about.'" Here, Badaracco summarizes what he learned:

> *First, in many cases [they] received explicit instructions from their middle-manager bosses or felt strong pressures to do things they believed were sleazy, unethical, or sometimes illegal. Second, corporate ethics programs, codes of conduct, mission statements, hotlines, and the like provided little help. Third, many of the[m] believed that their company's executives were out of touch on ethical issues, either because they were too busy or because they sought to avoid responsibility. Fourth, the[y] resolved the dilemmas they faced largely on the basis of personal reflection and individual values, not through reliance on corporate credos, company loyalty, [or] the exhortations of senior executives.*

Badaracco's interview subjects, who worked in banking, consulting, accounting, and advertising, came to believe they had to respond to the following "powerful organizational commandments:"

> *First, performance is what really counts, so make your numbers. Second, be loyal and show us you're a team player. Third, don't break the law. Fourth, don't over-invest in ethical behavior.*[31]

What do these findings suggest about the role of whistleblowers inside large corporations?

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CHAPTER PROBLEMS

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1. What should be the result when an employee-at-will is fired for being a Good Samaritan? Kevin Gardner had a job driving an armored car. At a scheduled stop at a certain bank in Spokane, Washington, he waited in the vehicle while his co-worker was in the bank. Suddenly he spotted a woman, whom he recognized as the manager, running out of the bank screaming, "Help Me!" Chasing her was a man with a knife.

> *Gardner described the expression on her face: "It was more than fear. There was a real—it was like a horrified kind of a look, like you—I can't describe it other than that, I mean she—she was horrified, not just afraid." Gardner looked around the parking lot and saw nobody coming to help the manager. After the manager and the suspect ran past the front of the truck, Gardner got out, locking the door behind him. As he got out of the truck, he temporarily lost sight of the manager and the suspect, who were both on the passenger side of the truck. While out of Gardner's view, the manager reached a drive-in teller booth across the parking lot, where she found refuge. It is unclear whether the manager was safe before Gardner left the truck, but by the time Gardner walked forward to a point where he could see the suspect, the suspect had already grabbed another woman who was walking into the bank. Gardner recognized the second woman as Kathy Martin, an employee of Plant World, who watered plants at the bank. The suspect put the knife to Ms. Martin's throat and dragged her back into the bank. Gardner followed them into the bank where he observed his partner with his gun drawn and*

31 Joseph L. Badaracco, Jr. and Allen P. Webb, "Business Ethics: A View From The Trenches," *California Management Review,* Vol. 37, No. 2 (Winter 1995).

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aimed at the suspect. When his partner distracted the suspect, Gardner and a bank customer tackled the suspect and disarmed him. The police arrived immediately thereafter and took custody of the suspect. Ms. Martin was unharmed.

Gardner's employer had a company rule forbidding armored truck drivers from leaving the truck unattended. Even if pulled over by someone who appears to be a police officer, drivers were instructed to show a card explaining that the driver would follow the police to the stationhouse. Gardner was fired for violating this absolute rule. He sued for wrongful discharge. What would be the arguments of the employer? Of the employee? See *Gardner v. Loomis Armored Inc.*, 913 P.2d 377 (Washington 1996).

2. The 2001 Enron Corporate Responsibility Annual Report contains this statement:

> *Enron employees . . . are trained to report without retribution anything they observe or discover that indicates our standards are not being met.*

In December 2001, using company equipment on company premises, an Enron employee posted a comment on an Internet message board revealing that Enron had paid $55 million in bonuses to its top people just before it filed for bankruptcy and laid off 4,000 workers. The employee who wrote this was fired. What ethical issues arise in this situation?

Enron's headquarters are in Houston. In Texas, wrongful discharge claims succeed only when an employee has refused to perform an illegal act, so if this whistleblower sues he would lose. What would be the legal result in Maryland? In New Jersey? In Montana?

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3. **Internet Assignment:** New Jersey's whistleblower law states that an employee cannot be fired for refusing to participate in an activity that he reasonably believes violates a law, is fraudulent or criminal, or goes against a clear mandate of public policy concerning the public health, safety, or welfare. William Scholtz was a security guard for Garden State Park. The park was hosting a prom when it received a bomb threat. Scholtz's supervisor told him to check the premises for a bomb, but he refused, claiming he had had no training in responding to bomb threats or in bomb detection. He was fired. Does Scholtz's argument fit within CEPA? What did the court decide? How would Scholtz have fared if he had worked in Maryland? In Montana?

4. Daniel E. Greer, who had spent nearly three decades studying technology and computer security, was chief technology officer for AtStake Inc., a firm that provides consulting services to Microsoft. In 2003, Greer was one of seven experts who wrote a report criticizing the U.S. government for relying too heavily on Microsoft software, claiming that the widespread dominance of the Windows "monoculture" made it too easy for hackers to spread viruses and to make trouble. Shortly after their report was published, Greer's job with AtStake ended. If he was terminated, what arguments might he make in a lawsuit? How might AtStake respond? What would be the most likely outcome if the company was located in Maryland? New Jersey? Montana? **Internet Assignment:** Find out what actually happened to Greer.

5. Ten months before the Enron debacle, a 30-year-old reporter with *Fortune* magazine, Bethany McLean, wrote an expose of the company, called "Is Enron Overpriced?" The most disturbing fact she revealed was the absence of solid information in Enron's financial reports. Three Enron Executives were flown to New York to try to convince the magazine not to publish the piece; Enron executive Jeffrey Skilling questioned Ms. McLean's research, calling her unethical; and Enron's CEO Kenneth Lay placed a call to the magazine's editor, claiming McLean was relying on a source who would benefit if Enron stock lost value. None of this pressure worked; the article was published anyway—although its message was largely ignored. What is at stake when corporate power attempts to silence the media?

6. Cindy Schlapper was responsible for advertising and promotion for Ran Ken, a corporation that ran a chain of 24 restaurants and bars called Chelsea Street Pubs. In 1994, the company cosponsored a nationwide contest with Remy-Amerique, a liquor company. The manager of

a Chelsea Pub in Texas won a trip to Las Vegas by selling the most margaritas containing Cointreau, a Remy-Amerique product. Although everyone involved at the time thought it was illegal under Texas law for a liquor company to pay for the promotion, Schlapper's boss ordered her to prepare a fake invoice, charging Remy-Amerique for table tents:

> *Knowing that no such table tents had been prepared for . . . Remy-Amerique, Ms. Schlapper inquired about the purpose for the invoice . . . [H]er supervisor told Ms. Schlapper that the invoice would allow Ran Ken to be reimbursed for the Las Vegas trip-prize which had cost the company $630. However, Ms. Schlapper was instructed to make the invoice out in the uneven amount of $631.80 to make the invoice "look good, make it look real." Ms. Schlapper was even ordered to include some phony sales tax to make the invoice look authentic. Recognizing that this whole transaction did not pass the "smell test," Ms. Schlapper expressed discomfort and refused to prepare the invoice. After her supervisor called her a "bitch" and ordered her to take the matter up with the company vice-president, Ms. Schlapper's inquiry, which ultimately got her fired was, "Exactly what are the legalities of doing this?"*

Ms. Schlapper sued for wrongful discharge. As it turned out, the Texas law applied to beer companies, not liquor companies. Because of this fluke, the invoice would not have been illegal, and Schlapper lost her case.

What is the "smell test?" Can you think of an argument against relying upon intuitive tools like the "smell test" as a moral compass?

7. The following is a quote from Johnson & Johnson's corporate "Credo":

> *We are responsible to our employees, the men and women who work with us throughout the world. Everyone must be considered as an individual. We must respect their dignity and recognize their merit. They must have a sense of security in their jobs. Compensation must be fair and adequate, and working conditions clean, orderly and safe. Employees must feel free to make suggestions and complaints. There must be equal opportunity for employment, development, and advancement for those qualified. We must provide competent management, and their actions must be just and ethical.*

As vice president of R&D for Therakos, a subsidiary of Johnson & Johnson, Daniel Tripoldi was responsible for the development of a new device called Centrinet. The company had already developed a device that had been approved to treat lymphoma. Centrinet was the name it chose for an improved version of the device, which Therakos now wanted to market as a means of treating another condition known as scleroderma. Tripoldi began to have reservations about these plans. In his opinion the already-approved device and the Centrinet were "sufficiently different in structure and operation that, under FDA regulations, new clinical tests would be required to establish Centrinet's efficacy." But the new tests would delay the marketing of the product. Tripoldi continued to raise his concerns with the company president—who was not a scientist—and others, insisting that what Therakos planned to do would violate FDA regulations. He was fired.

Tripoldi sued, claiming that his termination violated the Johnson & Johnson Credo, which, ironically, he had helped write! Look at the Credo. Would it support Tripoldi's claim that the company had made an implied promise to him not to fire him except for a good reason? A promise not to retaliate against him for expressing his concerns? Is there any other claim he might make? How should the court rule? *Tripoldi v. Johnson & Johnson and Therakos, Inc.,* 1877 F.Supp. 233 (D.N.J. 1995).

8. In this chapter, we have looked at how the law may operate to protect employees who have been punished for blowing the whistle. But another approach is to give people an incentive to become whistleblowers in the first place—to encourage them to take the risk of coming forward. The federal False Claims Reform Act gives any citizen the right to file a civil suit

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against any company he knows is cheating the government. The government prosecutes the claim, and the whistleblower is then eligible for between 15 and 25 percent of whatever the government is able to collect, while being protected against retaliation by the company.[32]

A plaintiff under this law is called **qui tam,** an abbreviation of a Latin phrase that may be translated as "who sues on behalf of a king as well as for himself."[33] The law has been amended three times, with the most significant change in 1986 when it was strengthened to help the government fight fraud, particularly in defense and health care contracts. The most recent qui tam successes have been focused on the health care industry. In 1998 SmithKline Beecham settled for $325 million the charge that it had defrauded the government by performing unnecessary tests, double-billing, and paying in-kind kick-backs to doctors in exchange for Medicare patients' business. In October 2001, qui tam whistleblowers made possible an $840 million settlement against the largest hospital chain in the United States—the biggest fraud settlement to date.

Qui tam cases are mutually advantageous to the Justice Department, which can receive triple damages, and to the whistleblowers. As the scope of such recoveries increases, industry representatives have expressed frustration with the law. They argue it cuts against company loyalty by discouraging employees from using internal reporting mechanisms to stop wrongdoing, and by offering huge incentives for employees to bring their employers down.

Is the False Claims Act a sensible response to the problem it seeks to address? Or does it turn employees into bounty hunters, too eager to turn against their employers? To help you think about this, check http://www.quitam.com or http://www.taf.org.

9. Seven months after the Columbia shuttle crashed, in August 2003, a report on the causes of the disaster was released. It had been a gargantuan effort. Some 25,000 workers had gathered more than 84,000 pieces of debris by walking slowly across eastern Texas and western Louisiana, collecting evidence. According to the final report, the "broken safety culture" inside NASA was at least as much to blame for the crash as the chunk of foam tile that blew a hole in the wing of the Columbia just after liftoff. Engineers, hoping a high-risk rescue might be possible, had asked management for outside assistance in getting photos of the damage, but these requests were rejected:

> *As much as the foam, what helped to doom the shuttle and its crew, even after liftoff, was not a lack of technology or ability . . . but missed opportunities and a lack of leadership and open-mindedness in management. The accident "was probably not an anomalous, random event, but rather likely rooted to some degree in NASA's history and the human spaceflight program's culture."*[34]

Similar problems appear to have affected the CIA in the months leading up to the U.S. invasion of Iraq. According to a scathing congressional report released in July 2004, key assessments used to justify the war were not supported by the government's own evidence:

> *Among the central findings, endorsed by all nine Republicans and eight Democrats on the committee, were that a culture of "group think" in intelligence agencies left unchallenged an institutional belief that Iraq had illicit weapons; . . . and that intelligence agencies too often failed to acknowledge the limited, ambiguous and even contradictory nature of their information about Iraq and illicit arms.*[35]

Studies have shown that, within large organizations, there is a tendency to go along with the majority. Most people are not likely to challenge the worthiness of the task at hand, or the way

32 31 U.S.C. Sec. 3730.

33 *Black's Law Dictionary,* 1251 (6th ed., 1990).

34 John Schwartz and Matthew Wald, "Report on Loss of Shuttle Focuses on NASA Blunders," *New York Times,* August 27, 2003.

35 Douglas Jehl, "Senators Assail C.I.A. Judgments on Iraq's Arms as Deeply Flawed, *New York Times,* July 10, 2004.

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in which the task at hand is being accomplished. This reality, combined with the pressures that affect an organization from the outside—time and money pressures in the case of NASA's Columbia shuttle, political pressures in the case of the United States in Iraq—can obscure good judgment.

Could there be advantages, for large corporations, in countering the "group think" tendency? Could employees who challenge the status quo be valuable? If so, how might corporate culture make room for them without risking destructive effects?

Chapter Project

Enron Stakeholder Role Play

You will be a member of one of these teams:

- Board of Directors: Enron board of directors, excluding management
- Accountants: Arthur Andersen, and the accounting industry as a whole
- Management: senior management at Enron (Fastow, Skilling, Lay, etc.)
- Government: regulatory agencies (OPIC, FERC, FCC, SEC), Congress
- Banks: investment banking firms and their research analysts
- Lawyers: Enron's in-house counsel and their principal firm, Vinson & Elkins

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Part 1: SELF STUDY: What part did your team play?

Research and write (approximately 3–4 pages double-spaced) a "self study," an explanation of your stakeholder group's role in the collapse of Enron. What did your group do (or fail to do) that contributed to the final outcome?

Part 2: DISCUSSION: Why did Enron collapse?

Preparation: Team self studies are distributed to all teams. All read them.

With your instructor as moderator, hold a discussion with representatives from each team about the question of why Enron went bankrupt. The goal is to put forward your team's best foot. Try to either justify any behavior that appeared to contribute to the downfall of the company or shift blame to other teams.

Part 3: THE CURE: What should be done?

In smaller mixed groups, in which there is one person representing each team, talk about the best way to prevent another Enron. Record your primary recommendations.

Part 4: EPILOGUE: Best Cure?

As individuals, evaluate the "cures" recommended by the different mixed groups. Select the one you believe best alleviates the circumstances that led to Enron. Now compare that with what actually happened. Look at the Sarbanes-Oxley Act, at litigation, at shareholder activism, and at any other developments that followed and responded to the collapse of Enron. Write your findings. Which looks like it would work best, the cure you selected or what has happened since 2001? Why?

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