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SPECIAL FEATURE

Dangers for counsel in Dodd-Frank whistleblower provision

By Stephen M. Honig

"Why should a man walk around with a pistol, and then let himself be insulted? That's mighty strange."

The Man with No Name, Clint Eastwood's iconic bounty hunter, pondered the question of why an armed person should not profit from his power. Congress must have been an Eastwood aficionado because they armed your employees with a gun that might prove to be very expensive for your company.

To understand the problem, we have to go back to the common law writ of qui tam.

A person assisting a sovereign in a lawsuit could receive a portion of the penalty. This historic device, embodied in the U.S. False Claims Act and in the Internal Revenue Code, came down to us under American law in the form of the "whistleblower," a person who brings suit on behalf of the government in exchange for a portion of the recovered damages.

Whistleblowing under Dodd-Frank

While the Sarbanes-Oxley Act contained protections against discrimination against employee whistleblowers, it took the enactment of Dodd-Frank last July to turn whistleblowing on publicly traded companies into big business.

The statute (Section 922) provides that a whistleblower who gives "original information" to the SEC that leads to a successful enforcement action with penalties exceeding $1 million "shall" receive a reward or bounty between 10 and 30 percent of the collected sanctions. This provision somewhat tracks the False Claims Act, under which the Department of Justice recovered $2.4 billion in 2009 and $24 billion since 1986.

Potential whistleblowers are not limited to, but do include, current or former employees. They can also be contractors, consultants, joint venture partners, sales agents, accountants not conducting an audit, journalists, analysts, professors or others dealing with a company wherein they can gather and provide original information to the government.

Over the last several years, the SEC and the DOJ have stepped up their Foreign Corrupt Practices Act enforcement. The whistleblowing bounty would be applicable to FCPA violations if called to the attention of the SEC.

Dodd-Frank also enhanced the Sarbanes-Oxley protections for whistleblowers, clarifying that retaliation is barred both by parent companies and affiliates whose financial information is included in consolidated reports.

Additionally, the whistleblower is now permitted to sue a retaliating employer directly in federal court without first exhausting administrative remedies.

Dangerous future of conflicts

Dow Jones reported last September that the SEC is offering some key protections for informants.

For example, the informants may choose to remain anonymous and cooperate with the SEC through an attorney. They will also have the right to appeal if denied a whistleblower payout and will have the right to a jury trial if they sue an employer for retaliation after assisting the government.

Counsel should expect whistleblower referrals to government agencies to increase. Already, a Google search of "whistleblowers" turns up advertisements for numerous law firms seeking to represent whistleblowers bringing complaints to the SEC under the new statute.

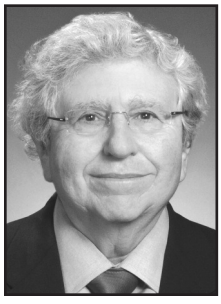
Whistleblowers themselves can access the SEC complaint form online at www.sec.gov, which allows the submission of tips under categories such as price manipulation, fraudulent or unregistered sale of securities, Ponzi scheme, insider trading, false and misleading SEC reports, failure to file reports, naked short selling, theft of funds or securities, bribery of foreign officials and others.

It is not surprising that industries subject to the False Claims Act and other qui tam statutes historically have experienced more whistleblowing employees, presumably by reason of the attractiveness of the qui tam bounties. Reportedly, employees account for 46 percent of fraud detection when a qui tam bounty is offered, but just 16.3 percent when it is not available.

The qui tam system creates a fundamental conflict for your employees. Controlling internal documents, such as codes of ethics and specific whistleblower policies, are designed to induce employees with information about possible wrongdoing to report it to corporation officers or boards of directors.

Say your employee uncovers evidence of a possible $10 million fraud. The employee can comply with company policy and advise them or go directly to the SEC and shoot for a bounty of a couple million dollars and still keep his job. Even scarier, an employee could allow a problem to grow before reporting it in order to ensure that the $1 million penalty threshold is reached.

Can a company draft a policy for its employees requiring that information about possible wrongdoing must be reported to the appropriate corporate officers in the first instance and not to regulatory agencies such



Stephen M. Honig is a partner in Duane Morris' corporate department in the firm's Boston office. You can reach him at smhonig@duanemorris.com.

as the SEC? Such a prohibition appears to violate public policy and the clear intent of Dodd-Frank.

Can a standard be crafted that such information must be brought first to the company, except in cases where it is credibly believed by the whistleblower that such reporting would cause the wrongdoing to be ignored, or otherwise covered up? Again, it is hard to believe that such a subjective standard would survive challenge in light of the intention of Congress.

It is unclear how the SEC, which encourages issuer self-policing, would react to an employee who sidestepped internal procedures in order to blow the whistle.

By analogy, the SEC's enforcement manual, which considers the degree to which cooperating individuals notified management, the board or auditors of wrongdoing, you would expect that the SEC would have trouble paying bounty to an employee who ran to whistleblow before following company policy.

But since virtually all companies have such a policy, does that mean that no employee will ever get a bounty or that bounties will be paid only if an employee reports internally but is ignored? And how would that result square with the seeming statutory requirement of a mandatory minimum 10-percent bounty?

We await SEC rule-making to ideally clarify this area.

Duties under Part 205

Title 17, Part 205 of the Code of Federal Regulations requires attorneys practicing before the SEC to evaluate and "report up" within a company hierarchy possible violations of securities laws or fiduciary duties. Could such counsel become a whistleblower and collect a bounty by contacting the SEC, even if such action is inconsistent with Part 205?

Or, could counsel go to the SEC first and then pursue counsel's obligations by reporting the facts to the company? And does in-house counsel in a public company in fact "practice" before the commission?

Almost certainly, the broad definition of "practice" in Rule 205.2 includes the provision of advice with respect to the securities laws or commission rules regarding any document that will be filed, and general counsel certainly reviews SEC filings.

Rule 205.3(a) makes it clear that an attorney practicing before the commission has professional and ethical duties to the issuer organization. Would those duties be breached by whistleblowing to the SEC?

The purpose of the SEC's statement is to make it clear that the attorney does not owe a duty to any individuals who might have taken improper action; the language is intended to free counsel to pursue wrongdoing against individuals who might otherwise claim that there was a breach of attorney-client privilege. But if the duty is to the company, is that duty breached by blowing the whistle?

The duty of an attorney under 205 is to communicate information either to the issuer's chief legal officer, to both the chief legal officer and the chief executive officer, or to a qualified legal compliance committee. Counsel is also obligated to pursue information to make sure that it is appropriately and internally evaluated.

So how can this be parsed with whistleblowing for bounty? There seems to be no prohibition against counsel as whistleblower. There seems to be a prohibition against firing counsel even though it can be argued that blowing the whistle violates counsel's duty to its client organization.

Or, will the SEC, long a champion of turning attorneys into gatekeepers, simply refuse by rule or by practice to ever give a bounty to in-house counsel, whose very job is to pursue wrongdoing in exchange for only his or her stated salary?

Dodd-Frank's monetization of business ethics no doubt will constitute efficient enforcement at one level, but there may be costs: costs in loyalty to the company and in the proliferation of claims, many of which will no doubt prove erroneous.

The risks to company reputation and stock price derived from precipitous whistleblowing, as well as the extra expense of scrambling to catch up to a regulatory inquiry should give in-house counsel pause. NEIH

Early look at newly proposed whistleblower rules

The U.S. Securities and Exchange Commission proposed extensive whistleblower rules in a 181-page release issued Nov. 3 that defies easy summarization (Release 34-63237 at www.sec.gov/rules/proposed).

The SEC poses numerous questions to the public in an effort to resolve some of the issues I raise in "Dangers for counsel in Dodd-Frank whistleblower provision."

Proposed regulation 21F addresses:

- Tension between reporting to the SEC and employee compliance with corporate obligations to report wrongdoing.
- Disqualification from bounty eligibility of members of the compliance structure, including attorneys, auditors and the like.
- Qualifying information that must be received before any formal or informal governmental inquiry has commenced, and must not only highlight a potential securities law violation but also be "connected to evidence that plays a significant role in successfully establishing" a case.
- Protecting anonymous whistleblowers, requiring them to submit information through an attorney.
- The forms required by the whistleblower office that must be under the pains of perjury.
- Bounty payments and amnesty for whistleblowers who themselves had involvement in the wrongdoing.

The release implicitly recognizes the complexity of whistleblowing by its sheer length and by the inclusion of an extensive explanatory chart that attempts to clarify when a bounty will be paid.

While others may become enriched, it will be difficult for lawyers to qualify for bounties. While someone must submit "independent knowledge" or "independent analysis," two of the seven exceptions to these definitions affect counsel.

First, information cannot be obtained under attorney-client privilege.

Second, information even if not privileged, cannot be obtained through certain representations, including representation of a whistleblower, for example, from an opponent's document production. Even these exceptions have subtexts, so counsel simply must read the whole release to get properly oriented.

Finally, counsel may want to ponder the ultimate anomaly, that while lawyers will find it virtually impossible to qualify for a bounty payment even though the SEC views them as the gatekeepers, there are detailed provisions parsing the when and how of paying bounties to persons who themselves share culpability.

Whistleblowers cannot get bounties for recoveries paid by themselves or by an entity that has liability based on the actions of that whistleblower. But a culpable whistleblower can be subject to prosecution — there is no automatic amnesty — while still qualifying for some sort of bounty payment.

Whether an employee who qualifies for bounty and is protected in his employment as a whistleblower can be fired if eventually criminally implicated in the very misconduct that earned the bounty, is a logical conundrum that begs for resolution in what would no doubt be fascinating litigation.

— Stephen M. Honig