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# **When the Whistle Blows**

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# CORPORATE counsel

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## When the Whistle Blows

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On August 18 a compliance officer at Interactive Brokers LLC in Chicago called the Securities and Exchange Commission to report that two men in Spain had been trading suspiciously in the stock of a company that had jumped 27 percent the day before. The compliance officer suspected insider trading.

Two days later, the SEC filed an emergency complaint in federal district court in Chicago. It accused the two men of having inside knowledge of a takeover attempt that caused the company's stock to jump, and it sought to freeze their over \$1 million in profits. The case is believed to be the first public legal action to fall under the latest financial reforms, called the Dodd-Frank Wall Street Reform and Consumer Protection Act. And it means that the compliance officer might be entitled to a sizable reward under the act's controversial whistle-blower provisions.

Though this was one of the first tips since the new law passed on July 21, in-house counsel fret that many more will follow. The SEC sees the whistle-blower law as a way to enhance its enforcement by, in effect, deputizing every employee of a public company to be a watchdog. The law's whistle-blowing provisions also bar retaliation by employers, and penalize companies that act against whistle-blowers. It beefs up the SEC's powers to act on complaints. And, among other provisions, it expands coverage to acts that occur outside the United States.

While in-house legal departments are eager to embrace compliance, most GCs are worried about what the law will mean to their companies in the long run.

One of them is David Brooks, general counsel of New York-based Fortress Investment Group LLC. While Brooks believes that better compliance will help restore investor confidence in the financial industry, he admits, "There is a lot of trepidation about the idea of giving [whistle-blowers] a bounty that could incent them to report made-up claims. Investigating claims of this nature is a real burden on resources."

Other in-house counsel are telling Bart Colli, a partner at Morgan, Lewis & Bockius in Philadelphia, that they are concerned about several aspects of the law. Colli, who retired as general counsel of Aramark Corporation last year, says one worry is a provision awarding double back pay to employees who are retaliated against. It also will encourage more claims, he says.

By all accounts, corporate counsel should be worried. Within weeks of the law's passage, plaintiffs attorneys across the country reported a surge of calls from would-be whistle-blowers. Erika Kelton, partner at the plaintiffs powerhouse Phillips & Cohen in Washington, D.C., says, "We're inundated."

Another lawyer, Rebecca Katz, a partner at Bernstein Liebhard in New York says, "I've had many, many more whistle-blowing calls in the last three weeks than I had in the last three years." And several law firms have created separate Web sites to lure whistle-blower plaintiffs. For example, Stuart D. Meissner LLC in Manhattan just launched its site [secsnitch.com](http://secsnitch.com).

Even the SEC acknowledges that the tips are already coming in. Spokesman John Heine, while not revealing any specific numbers, says, "We are expecting a significant increase in the number of complaints." Heine says the agency is still writing rules (the law gave the SEC 270 days to do that), but the bounties were effective immediately.

The U.S. Department of Justice, too, expects a surge of complaints. Last February someone at the annual White Collar Crime Conference asked Denis McInerney, chief of the Justice Department's fraud section, what the lawyers will be talking about most at next year's conference. "Whistle-blowers," McInerney replied, without missing a beat.

Whistle-blower statutes are not new. Whistle-blowing itself dates back to 1912, when the Lloyd-La Follette Act granted protection to federal employees who complained to Congress about incompetence, corruption, or other problems. Since then Congress has passed at least 19 whistle-blower provisions in various laws, dealing with everything from clean air and water to energy reorganization, transportation, and pipeline safety, among other things.

Then came the False Claims Act, with significant amendments in 1986. This act allows nongovernment employees to file private suits, called *qui tam* actions, against federal contractors who try to defraud the U.S. If successful, the whistle-blower can receive up to 25 percent of any recovered damages. Since 1987, the government has recovered some \$22 billion under the act, and several whistle-blowers have reaped millions in rewards [see "A Tale of Two Whistle-Blowers," below]. But these rewards have been an exception, even though Congress expanded whistle-blower protections.

More recently, the Sarbanes-Oxley Act of 2002, passed in the aftermath of the Enron scandal, extended broad protections to employees of public companies who complained about fraudulent conduct. Yet the financial reward to whistle-blowers under "SOX" has averaged only about \$32,000 per person, hardly worth most people risking their job for.

Critics blame the Occupational Safety and Health Administration, which enforces the SOX provisions along with previous whistle-blower statutes, for the poor treatment of SOX tipsters. Law professor Valerie Watnick, of Baruch College's Zicklin School of Business in New York, says OSHA upholds only a small number of the SOX whistle-blower complaints. She was one of the first, in a law review article in 2006, to point out "the deficiencies for whistle-blowers under SOX."

A more recent study supports Watnick. The study, by the nonprofit Center for Public Integrity in Washington, D.C., showed that OSHA upheld only 25 whistle-blower claims out of 1,066 filed under SOX through June 30 of this year. That's a mere 2 percent win rate.

Defense attorneys assert that those figures prove that most claims are frivolous. But a report released by the U.S. Government Accountability Office in September sided with the critics. The report cited "long-standing program weaknesses" at OSHA. It said that many whistle-blower complaints are not investigated, and some aren't even recorded in OSHA's database. Nearly half of the whistle-blower investigators lack the necessary computer equipment, training, and resources, according to the GAO auditors. And money intended to pay whistle-blowers goes into a general fund at OSHA, is not tracked, and probably is spent on other things, the report said.

OSHA's parent, the U.S. Department of Labor, has responded to the critics by issuing new regulations for whistle-blower claims. And OSHA has unveiled a new Web site and vowed to be more receptive to, and protective of, whistle-blowers. But at least one advocacy group, Public Employees for Environmental Responsibility, says that that is not enough. The group has called on Labor secretary Hilda Solis to elevate the whistle-blower program into its own office.

The Dodd-Frank Act attempts to aid whistle-blowers by circumventing OSHA. Tipsters can now report violations directly to the SEC or the Commodities Futures Trading Commission, and it provides a possible reward of 10-30 percent of any recovery over \$1 million. If a company discharges an employee for whistle-blowing, the employee can receive double back pay.

The rewards mean that the SEC could have its hands full sifting through tips and determining their validity. The agency plans to add another 800 employees to help deal with the wide-ranging Dodd-Frank requirements. Beyond whistle-blowers, the act includes new provisions for corporate governance, proxy access, executive compensation, market regulation, disclosure, and more.

Until the new office for whistle-blowers is established, the SEC is receiving complaints through its existing Center for Complaints and Enforcement Tips, as well as through online forms on its Web site.

Attorney Frederick Rivera joins Brooks and others in voicing the most common GC fear—that the financial incentives are so huge that companies will be flooded with bogus complaints. Rivera is cochair of the financial services litigation and investigations group at Perkins Coie in Seattle, and was formerly an in-house counsel at Fannie Mae, where he oversaw internal investigations. The SEC, Rivera says, has stated that the point of the bounty incentive is to increase the quality of tips. "But the counterargument is that it will actually cause you to get more tips without substance," Rivera insists.

However, Rivera notes that any person who knowingly makes a false accusation can be prosecuted.

For its part, the SEC has tried to allay some fears. In his September testimony before the Senate Judiciary Committee, the SEC's director of enforcement, Robert Khuzami, assured senators that "we will be mindful of competing interests." He said these interests include encouraging whistle-blowers to provide quality tips while not creating "undue burdens on the commission and the constituencies that we protect and regulate that could result from groundless whistleblower submissions."

Another aspect of the new law that is especially troubling to experts is its use under the Foreign Corrupt Practices Act. Alexandra Wrage, president of the nonprofit antibribery group Trace International, Inc., says it encourages the people closest to the wrongdoing, who should be working to correct the problem, instead to conceal it while the potential recovery amount builds. Wrage imagines "a scenario whereby an employee, still on the company's payroll, is using his position to photocopy documents and collect evidence of a bribery scheme instead of working to resolve the problem.

With millions of dollars in play, this will be seen as a lottery ticket by some."

She admits that the new law may lead to more self-disclosure of FCPA violations by companies. "I just question whether this is the right approach," Wrage adds.

Some other provisions of the law also worry corporate lawyers. Eugene Scalia, cochair of the labor and employment group at Gibson, Dunn & Crutcher in Washington, D.C., questions one item that allows plaintiffs to eventually take a case to federal court if they choose. "In fairness, employers ought to have an equal ability to remove a case to federal court," Scalia says.

Scalia, who served as the solicitor of the Department of Labor and oversaw the implementation of the SOX whistle-blower provisions, sees the one-sidedness as a legal flaw in Dodd-Frank. "It raises constitutional questions when plaintiffs have the ability to obtain a jury trial and defendants don't have the same opportunity," he says.

Another lawyer who sees a minor flaw is Katz. Despite being a plaintiffs attorney now, she was a senior counsel in the enforcement division of the SEC in the late 1990s. Katz says the act seems to allow a person who was part of the fraud but not criminally prosecuted to still receive a reward. Katz explains that she believes anyone civilly charged as part of the fraud shouldn't be eligible for a reward. "But it doesn't outweigh the overall benefits of the act," she adds.

Punishing whistle-blowers who were part of the fraud is not a good idea, argues Dean Zerbe, a lawyer for whistle-blowers. Zerbe, partner at Zerbe, Fingeret, Frank & Jadav in Washington, D.C., says securities and tax fraud are too complex for most people to understand, "Having someone knowledgeable come in with inside information is like giving prosecutors a key to the kingdom," Zerbe says. But if these inside whistle-blowers are not protected or rewarded, Zerbe warns, they won't risk losing their jobs.

So what does the new whistle-blower law mean to general counsel? The quick answer: Prepare.

First, corporate counsel should get ready to spend more. They'll have to sign more checks for training, enhanced compliance programs that must cover subsidiaries now, more internal investigations, more internal audits. And more litigation.

As Colli and others point out, several parts of the law—the bounty, longer statutes of limitations, right to jury trial, ban on arbitration agreements, and the right to remain anonymous—all encourage more litigation by employees. "So we're telling clients that you really need to focus on ways to encourage reporting internally under your compliance program first," Colli says.

He recommends that a company evaluate how well managers deal with employee complaints, before a worker seeks outside legal advice. "Compensation decisions should include whether compliance is encouraged," he advises.

And watch out for disciplined or disgruntled employees. Sarah Bouchard, a partner and colleague of Colli's at Morgan, Lewis, suggests investigating and documenting every employee's complaint in-house. She recommends centralizing the compliance process as well as the record-keeping. "The statute of limitations under Dodd-Frank can be as long as ten years," she warns, "so it will require new record-keeping that a company must be aware of to properly defend itself."

Many companies will need to hire more lawyers and forensic accountants. Brooks, the GC, says his investment firm already has 15 of his 50-person legal department assigned to compliance, most of them lawyers. But he expects to hire more compliance experts to deal with all the Dodd-Frank financial reforms.

Rivera agrees that it's worth hiring more lawyers for in-house probes. He recalls that at Fannie Mae he learned the importance of letting employees raise concerns internally and then thoroughly reviewing their complaints. "If that process is not in place, and the employee can't be heard, then they will go outside the company," he warns.

Another area to check out is corporate insurance liability coverage. Leon Kellner, a partner in the insurance group at Dickstein Shapiro in Washington, D.C., says he expects the new law to affect policyholders because fraud investigations are generally covered by insurance. "You'll see the insurance companies either raise premiums or start putting exclusions into the policies, carving out things where they have difficulty forecasting what will happen," says Kellner, who served as U.S. attorney in Miami from 1985 to 1988.

Finally, companies are preparing to take part, either directly or indirectly through industry groups, in the SEC rule-making process. The SEC is already accepting public comments on what the rules should include. Rivera expects corporations to lobby hard on shaping the rules. Corporate executives want the regulations to define what good faith means in a claim, or they want a disincentive for an employee who raises a complaint without substance and disrupts the company. "The real meat will be in those regulations," he says.

One last piece of advice: A whistle-blower is protected from retaliation even if the company spends millions of dollars to investigate a claim that turns out to have no merit. "One of the hardest things to explain to companies about whistle-blower protections is that an employee can be flat-out wrong [though not knowingly] and still is shielded from discipline,"

Rivera says. •