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When a Whistleblower Walks: Dodd-Frank and the Challenges That Employee Departures Present

By Michael M. Farhang and Susannah S. Wright

Almost two years have passed since the Securities and Exchange Commission released its final rules regarding the "whistleblower" provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] Nonetheless, company counsel and compliance personnel are still adapting to the new challenges posed by what some employers perceive as financial incentives in the act for whistleblower employees to bypass internal compliance programs when reporting misconduct. These challenges may take on even greater complexity when the whistleblower is departing, or has already departed, from a company because the incentives for a departing employee to bring such complaints directly to his or her former employer may be reduced. Contrary to expectations, however, there are some approaches companies can follow that will both reinforce the proper role of compliance programs in detecting and remediating misconduct and, at the same time, promote law enforcement's legitimate interest in investigating and punishing wrongdoing.

Both the SEC and properly designed corporate compliance programs seek to encourage employees with information about wrongful activity to come forward so that misconduct that could cause financial loss or potential civil or criminal liability for the company can be stopped and appropriate remediation steps (e.g., employee discipline or termination, strengthening of internal controls, reporting to authorities, etc.) can be taken as soon as possible. In an effort to enhance the incentives for employees to come forward to law enforcement, the SEC's rules pursuant to the whistleblower provisions of Dodd-Frank (the whistleblower rules) now permit whistleblowers to become eligible for a potential financial bounty for providing original information about a securities law violation that results in a successful SEC enforcement action and a monetary penalty above a threshold amount.[2] Despite the common interest among well-intentioned companies and the SEC in ferreting out such violations, the whistleblower bounty rules do not require employees to report concerns internally through a company's compliance system either simultaneously with, or before, providing that information to the SEC.

Perhaps recognizing the possible incentives the whistleblower rules might create for employees to bypass company compliance programs, the SEC has carefully crafted the rules so as to encourage utilization of companies' internal reporting systems and also to discourage concealment of information about potential

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[1] 17 C.F.R. § 240.21F-l et seq.

[2] 17 C.F.R. § 240.21F-l. *See also SEC Adopts Final Rules Implementing Whistleblower Provisions of Dodd-Frank*, Gibson Dunn Client Alert, May 31, 2011; Michael Farhang and Susannah Wright, *Dealing with Tipsters Under Dodd-Frank*, The Recorder, June 27, 2011.

misconduct from employers. Nonetheless, some commentators (including the U.S. Chamber of Commerce) have argued that the rules still provide an incentive for employees to report potential concerns directly to the SEC without also using a company's internal reporting system, potentially hindering a company's ability to detect misconduct at an early stage and engage in swift remedial action.[3]

Departing Employees

The difficulties of maintaining the relevance of corporate compliance programs in the case of whistleblower complaints can increase in the case of employees departing from the company, whether voluntarily or involuntarily. In such situations, a departing employee, especially one who leaves the company with grievances, may have little motivation to voluntarily disclose issues to company personnel, especially when the employee is planning to disclose (or already has disclosed) the issues directly to law enforcement. In such a situation, the company's ability to investigate and put an immediate stop to the wrongdoing at the same time the government may be commencing an investigation may be significantly delayed.

For instance, consider a situation in which an employee has information about a potential securities law violation that is occurring at his or her company. That employee decides to leave the company, but does not report the alleged misconduct through the company's compliance program. Instead, the employee provides the information after his or her departure to the SEC, which will need time to evaluate the information and decide whether to take steps to initiate an investigation. This evaluation could include initiating the process of obtaining a formal order of investigation or simply issuing informal requests for information. During this time, the SEC might not be in a position to alert the company to the exact nature of the issue for some time, perhaps even weeks or months. Even a quick initial inquiry (whether formal or informal) from the SEC for information or documents might not fully make clear to the company the substance of the whistleblower complaint or the exact nature of the misconduct alleged.

In this situation, the company has lost an opportunity to intervene at an early stage to investigate and stop ongoing misconduct involving an aspect of its business operations. Moreover, what if the now-former employee ultimately elects not to cooperate with the company's subsequent investigation, further hindering the company's ability to identify wrongdoers and prevent other, potentially ongoing violations? The likelihood of internal reporting may be lessened even further if the former employee was actively involved in the misconduct. The whistleblower rules acknowledge that whistleblowers who engaged in the complained-of conduct may still be eligible for a monetary award, even if they are ultimately prosecuted or fined for that conduct.[4] The SEC has expressly stated that "one effective way to bring about justice is to use a rogue to catch a rogue."[5] Rules 21F-6 and 21F-16 therefore permit a culpable whistleblower to be eligible for an award but limit the amount of award based on the whistleblower's culpable conduct.[6]

The company's ability to address the critical facts regarding the wrongdoing may be further complicated when a departing employee believes he or she has been terminated due to complaints about potential securities law violations at the company. That employee may then seek to invoke the whistleblower protections of Dodd-Frank or the Sarbanes-Oxley Act of 2002[7] and sue the company for retaliation or wrongful termination under those provisions (or at common law), claiming that the reason for termination was his or her raising of concerns about alleged misconduct.[8] In this situation, the company will be faced with the difficulties of conducting an investigation into the potential violation while engaging in defensive litigation against a key witness to the same conduct.

Separation Agreements

Can agreements with departing employees help to promote greater internal reporting of compliance concerns without stifling legitimate reporting to outside authorities? Companies often ask departing employees to sign separation or severance agreements that seek to limit potential litigation exposure and protect the company's trade secret and confidential information after the employee's departure in exchange for monetary payment. However, in light of the Dodd-Frank whistleblower rules, questions have arisen about whether certain language sometimes found in such agreements could have the effect (whether intended or unintended) of inhibiting or restricting employees from contacting the SEC about alleged securities violations.

SEC rules expressly include a provision prohibiting attempts by employers or others to prevent an individual from making a report to the SEC about potential misconduct. Specifically, Rule 21F-17(a) of the whistleblower rules states:

> No person may take any action to impede an individual from communicating directly with the Commission staff

[3] *See, e.g., U.S. Chamber Warns New SEC Whistleblower Rule Will Undermine Corporate Compliance Programs*, U.S. Chamber of Commerce Press Release (May 25, 2011); Abigail Caplovitz Field, *Court Whistleblowing Ruling Undercuts Compliance Programs*, Corporate Secretary.com (July 22, 2013).

[4] 17 C.F.R. §§ 240.21F-6 and 240.21F-l6.

[5] SEC Release No. 34-64545, Implementing the Whistleblower Provisions of Section 21F of Securities Exchange Act of 1934, May 25, 2011 (adopting release), at 194.

[6] 17 C.F.R. §§ 240.21F-6 and 240.21F-l6.

[7] 18 U.S.C. § 1514A.

[8] Courts are currently split as to whether an employee who reports a potential securities violation through a company's internal reporting mechanisms constitutes a whistleblower protected from retaliation under the whistleblower rules. The majority of courts have held that an employee who reports internally is protected from retaliation just as if he or she had made the report directly to the SEC. *See, e.g., Egan v. TradingScreen, Inc.*, No. 10 Civ. 8202(LBS), 2011 BL 339160 (S.D.N.Y. May 4, 2011); *Kramer v. Trans-Lux Corp.*, No. 3:11cv1424 (SRU), 2012 BL 249583 (D. Conn. Sept. 25, 2012); *Nollner v. S. Baptist Convention, Inc.*, 852 F. Supp. 2d 986, 995, 2012 BL 78371 (M.D. Tenn. 2012); *Genberg v. Porter*, 1:11-cv-02434-WYD-MEH, 2013 BL 80178 (D. Colo. Mar. 25, 2013); *Murray v. UBS Secs., LLC*, No. 12 Civ. 5914(JMF), 2013 BL 134047 (S.D.N.Y. May 21, 2013). However, the U.S. Court of Appeals for the Fifth Circuit recently issued a ruling holding that the anti-retaliation provisions of the rules apply only when an employee reports to the SEC. *Asadi v. GE Energy (USA), LLC*, No. 12-20522, 2013 BL 160743 (5th Cir. July 17, 2013).

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> about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement (other than agreements dealing with information covered by § 240.21F-4(b)(4)(i) and § 240.21F-4(b)(4)(ii) of this chapter related to the legal representation of a client) with respect to such communications.[9]

The SEC has expressed some concern about the possibility that some separation agreements may contain provisions that could have the effect of limiting an employee's freedom to communicate with the SEC. Sean McKessy, chief of the SEC's Office of the Whistleblower, stated in October 2012 that his office was looking closely at the behavior of employers who use ''aggressive'' employment and severance agreements that may prevent employees from contacting the SEC. Specifically, he stated:

> If [lawyers] are drafting very aggressive language to intimidate employees, we want to know about it. The authors of that language might be held accountable.[10]

Some attorneys who routinely represent whistleblowers have complained about what they claim is a practice by some employers of inserting language into separation agreements that restricts employees' ability to bring whistleblower complaints and thereby could chill communications to the SEC. In a May 8 letter to the SEC, two such attorneys highlighted separation agreement provisions that require employees to (1) agree not to disclose or otherwise use company information except where required by ''order of a governmental agency or court after timely notice of the order has been provided to the company,'' (2) ''renounce'' the right to receive any rewards the SEC might provide in the event of a successful enforcement action, or (3) disclose any contacts with governmental agencies, including the SEC.[11] These attorneys and others have requested that the SEC modify the whistleblower rules or issue an opinion to expressly prohibit such agreements.[12]

In light of such concerns, companies and their counsel should exercise caution in drafting separation agreements seeking to restrict use of company information to ensure that such agreements do not create a perception or real effect of obstructing legitimate reporting to the SEC or to other governmental agencies. Further clarification of the SEC's position as to the contours of permissible language would be helpful, and may be forthcoming. In the meantime, some commentators have suggested precautionary language in all separation agreements clarifying that ''nothing in the agreement [sh]ould be construed to impair an employee's rights to communicate with, or participate in an investigation by, a [government] agency or law enforcement entity'' as a means to reduce the risk that such an agreement could be construed as discouraging external reporting.[13]

Additional Issues for Companies, Employees, and Courts to Consider

In other important respects, separation agreements that include provisions regarding employee certifications, cooperation with internal investigation, and protection of the attorney-client privilege can raise important questions about whether employer and law enforcement priorities are conflicting or complementary. In fact, the goals of employers and law enforcement in the case of whistleblowers may be more closely aligned than might otherwise be supposed. The SEC and other law enforcement agencies have a clear and legitimate interest in being able to take swift action based on reports of potentially unlawful conduct, an interest that Dodd-Frank seeks to promote. At the same time, companies and their compliance counsel likewise have important roles to play in aiding law enforcement by marshaling company resources toward the common goal of identifying and stopping such conduct at an early stage. The agreements reached between companies and departing employees can potentially serve an important role in promoting fact-finding both by the companies and by government regulators in the face of alleged misconduct.

1. Provisions That Encourage Reporting Through Compliance Programs

Provisions in separation agreements that require reporting of potential violations through corporate compliance channels arguably aid the common interests of employers and law enforcement in detecting and addressing wrongdoing. For a variety of business and legal reasons, companies have an incentive to ensure that employees leaving the company are not doing so because of their awareness or complaints of potential securities law violations. Companies have a clear interest in addressing the concerns of employees who legitimately believe they have been the victim of unlawful retaliation. In addition to the benefits of ensuring that misconduct (and any retaliation) are stopped, the consequences of ignoring employees' concerns could include litigation against the company, damaging media reports, and a perception among current employees that the company will countenance misconduct without taking action. Provisions requiring reporting can enable company compliance personnel to track down, identify, and stop the unlawful behavior and to ensure that employees are not being punished due to their knowledge of or concerns about potentially unlawful behavior.

The SEC has recognized that companies' internal compliance programs are valuable mechanisms for preventing and detecting misconduct.[14] The SEC's Dodd-Frank rules have included some important features designed to reduce potential disincentives for employees to resort to corporate compliance programs, even in the

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[9] 17 C.F.R. § 240.21F-l7(a).

[10] *Susan Beck's Summary Judgment: SEC's Whistleblower Chief Disappointed in Questions from Corporate America*, The American Lawyer (Nov. 26, 2012).

[11] Letter from Debra S. Katz and David J. Marshall, p. 3, at http://kmblegal.com/wordpress/wp-content/uploads/130508-Letter-to-SEC-Commissioners.pdf.

[12] *Id.;* David J. Marshall, *SEC Must Stop the Latest Effort to Impede Whistleblowers*, Law 360 (May 13, 2013); Michael Smallberg, *Court Order against Former News Corp. Employee Could Undermine Dodd-Frank Whistleblower Protections*, Project On Government Oversight (POGO) Blog (Feb. 2, 2012).

[13] William McLucas, et al., *Dispatches from the Whistleblower Front: Five Common Pitfalls for Employers to Avoid*, 45 Sec. Reg. & L. Rep. (BNA) 1345 (July 22, 2013).

[14] *See, e.g.,* SEC Release No. 34-64545, Implementing the Whistleblower Provisions of Section 21F of Securities Exchange Act of 1934, May 25, 2011, at 104.

first instance. As an example, the whistleblower rules include a 120-day ''look-back'' provision that gives employees an opportunity to report potential issues internally before reporting them to the SEC without losing their place in line for a later whistleblower bounty award based on ''original'' information.[15] In addition, a whistleblower who first reports internally may be eligible to receive an award if the company later discloses the information to the SEC and a successful enforcement action results.[16] Finally, the amount of a whistleblower's award may be positively or negatively affected depending on whether the whistleblower participated in a company's internal compliance program or whether he or she interfered with the compliance system.[17]

To further encourage such internal reporting, separation agreements sometimes include provisions seeking certification from the employee that he or she is not aware of any potentially unlawful activity that has not already been reported through the company's internal compliance reporting mechanism. In addition, companies sometimes include language seeking a statement of whether the employee believes he or she has been retaliated against for alerting the company to potential violations of the securities laws. If these provisions are not actually contained in a severance agreement, the topics are sometimes covered with questions in employee exit interviews so that employees have an additional opportunity to disclose any such information before leaving the company.

The law regarding the Dodd-Frank whistleblower rules in the context of separation agreements is not yet sufficiently developed to predict how the majority of courts will react to these types of provisions. Language that serves solely to encourage the internal reporting of potential misconduct, without inhibiting external reporting, can arguably serve a legitimate interest by encouraging employees to ensure that the company has sufficient information to address potential areas of concern upon the employees' departure. Such provisions would appear to serve the interests of both the SEC and companies in ensuring that compliance and investigations personnel have the opportunity to detect and put a stop to any ongoing misconduct and to deter such misconduct in the future.

2. Ensuring Cooperation in Post-Employment Investigations

Companies and regulators also have a common interest in encouraging former employees who may have information regarding potential misconduct to cooperate with any subsequent internal or government-led investigations into the conduct. Many companies include clauses in their standard employee codes of conduct reminding employees of the obligation to cooperate in any investigation conducted by the company during their employment. Although some attorneys have argued that such ''mandatory cooperation'' provisions in a separation agreement may impede the ''free and open'' communication between a former employee and the SEC,[18] an argument exists that such provisions can serve instead to reinforce both the company's and the SEC's abilities to obtain information regarding potential misconduct.

Language in separation agreements requiring soon-to-be-former employees to cooperate with future internal company investigations may assist fact-finding when subsequent allegations of misconduct arise and there are gaps in the company's institutional knowledge because the key witnesses have left. Given the significant incentives for a company's voluntary cooperation with an SEC investigation,[19] encouraging cooperation with a company's internal investigation in cases when the SEC is conducting a parallel investigation appears to serve both institutions' interests because in most, or many, cases the key findings of the company's internal investigation will end up being disclosed to the SEC as part of the company's voluntary cooperation.

In some circumstances, mandatory cooperation provisions can also help to resolve significant challenges to the government's ability to fully investigate misconduct. While the SEC may be able to compel certain former employees to testify or to produce documents through the use of subpoenas, the process of authorizing formal investigations and issuing subpoenas requires additional time and may slow down an investigation, potentially obscuring evidentiary leads and hindering the government's ability to understand the scope of any misconduct. Ensuring continued employee cooperation with a company investigation can help secure witness testimony and documentary evidence for government regulators on a speedier timetable. Further, there may be situations (as with overseas former employees or foreign companies) in which the critical witnesses or documents may be entirely outside of the reach of the SEC's subpoena powers. Provisions requiring a former employee to assist an internal investigation or risk breach of the agreement can serve an important law enforcement purpose by putting the company's compliance and legal resources at the disposal of the SEC and other regulatory agencies to ensure quicker government access to critical evidence.

3. Protections for Attorney-Client Privileged Information

A final key issue facing companies concerns the protection of attorney-client privileged information following an employee's departure. The whistleblower rules specifically state that attorney-client privileged information generally cannot be used in order to obtain an award.[20] Given the general prohibitions on law enforcement's invasion of the attorney-client privilege in conducting investigations and the consequences such invasions can have for the progress of investigations,[21] both

[15] 17 C.F.R. § 240.21F-4(c)(3).

[16] *Id.*

[17] 17 C.F.R. § 240.21F-6(a)(4).

[18] Letter, *supra* note 11, at pp. 10-11.

[19] SEC Release No. 44969, Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Oct. 23, 2001 (the ''Seaboard Report'' available at http://www.sec.gov/litigation/investreport/34-44969.htm).

[20] 17 C.F.R. § 240.21F-4(b)(4)(i). Some exceptions apply. Disclosure of information permitted under 17 C.F.R. § 205.3(d)(2) or state attorney conduct rules may be considered ''original information'' and eligible for use in the whistleblower program.

[21] *See, e.g.*, SEC Division of Enforcement (''As a matter of public policy, the SEC wants to encourage individuals, corporate officers and employees to consult counsel about potential violations of the securities laws. . . .***The staff should not ask a party to waive the attorney-client privilege or work product protection without prior approval of the Director or Deputy***

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companies and regulators have an interest in ensuring that privileged information is not misused by departing employees. Nonetheless, departing employees may not be aware of what constitutes information protected by the attorney-client privilege.

Separation agreement provisions regarding the continuing obligation to keep attorney-client protected communications confidential may provide an opportunity for the company to reinforce the message that the company holds a legitimate attorney-client privilege and that such information is protected from unauthorized disclosure.

Both the SEC and companies have strong interests in preventing the wrongful disclosure of attorney-client privileged communications in the whistleblower context. Leaving unaddressed the potential for wrongful disclosure of privileged information could have the potential to chill free and open communication between company counsel and employees about proper compliance with the securities laws. In most cases, the SEC would not be able to utilize such information in an enforcement proceeding in any event, and, as the SEC has recognized, ''compliance with the federal securities laws is promoted when individuals, corporate officers, and others consult with counsel about possible violations, and the attorney-client privilege furthers such consultation.''[22]

Director.'') (emphasis in original). Enforcement Manual (Nov. 1, 2012) at 95, available at http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

Conclusion

The SEC and companies have legitimate common interests in taking measures to encourage the reporting, detection, and remediation of misconduct. Moreover, the SEC has recognized that internal reporting mechanisms are a valuable tool in helping companies comply with the securities laws. Measures in separation agreements that serve to encourage departing employees to disclose potential misconduct, to cooperate in any subsequent investigations, and to protect the confidentiality of attorney-client protected communications, when appropriately drafted, can promote this compliance. Companies should ensure that such agreements do not jeopardize the SEC's strong interest in ensuring that potential whistleblowers are able to communicate freely both internally and externally about potential securities law violations. Properly tailored separation agreements can therefore serve the common interests of employers and law enforcement in enhancing both vigorous compliance programs and ensuring open access to law enforcement reporting channels.

[22] SEC Release No. 34-64545, Implementing the Whistleblower Provisions of Section 21F of Securities Exchange Act of 1934, May 25, 2011, at 56. *See also* Enforcement Manual (Nov. 1, 2012) at 95.