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2011 Sees Focus on Whistleblowing and Dodd-Frank Claims

By Chris W. Haaf and Monica C. Platt

In 2011, courts addressed a variety of securities law claims arising from the newly enacted Dodd-Frank Act. Signed into law in July 2010, passage of the Dodd-Frank Act was spurred in part by the Bernard Madoff Ponzi scheme in addition to other smaller-scale fraudulent schemes. It contains whistleblower provisions meant to both encourage reporting and expand protection from retaliation for informants. Dodd-Frank also expanded the Securities and Exchange Commission's (SEC) ability to bring aiding and abetting claims by allowing them to be brought under the Securities Act of 1933 and the Investment Company Act of 1940 in addition to the two other statutes under which they could already be brought. Many 2011 cases focused on the interpretation and the applicability of the whistleblower provisions (which included a fresh look at Sarbanes-Oxley's whistleblower provisions), but one court also considered the act's retroactivity in the area of aiding and abetting. The cases show that while Dodd-Frank may have expanded protections for informants, Sarbanes-Oxley is still very much in play. Both will likely continue to be major themes of 2012.

Whistleblowing Claims under Dodd-Frank and Sarbanes-Oxley

In 2011, a number of courts explored the intersection of the whistleblower provisions of the Sarbanes-Oxley Act and the whistleblower and bounty provisions of the new Dodd-Frank Act. In the wake of the Enron accounting scandal, Congress enacted Sarbanes-Oxley in 2002 in part as a response to a culture that discouraged employees from reporting fraudulent behavior, whether internally or to federal authorities. Under Sarbanes-Oxley, individuals successfully claiming whistleblower protection may be entitled to reinstatement, back pay, and special damages, including attorney's fees and costs. Sarbanes-Oxley's whistleblower provisions protect individuals from adverse employment action in retaliation for providing information on activity that is in violation of securities laws in addition to other federal laws relating to fraud against shareholders. Only a handful of the more than 1,400 retaliation complaints that have been lodged under Sarbanes-Oxley since its passage have been successful.

Dodd-Frank contains its own whistleblower provisions, including a bounty provision to encourage reporting. Prior to Dodd-Frank, the SEC's whistleblower provisions were limited to insider trading, with awards capped at 10 percent of penalties. Now, under Dodd-Frank, whistleblowers seeking a bounty stand to gain 10 to 30 percent of the money collected in sanctions in a successful action. Additionally, Dodd-Frank's provisions apply to individuals providing information to the SEC relating to any violation of securities laws. Similar to Sarbanes-Oxley, Dodd-Frank also has a retaliation provision, protecting informants against adverse employment action for providing information to the SEC; initiating, testifying in, or assisting in investigations or judicial or administrative actions; or making disclosures required or protected under various other federal laws and regulations. The remedies available under Dodd-Frank's whistleblower provisions are reinstatement, back pay with interest, and litigation costs.

Some commentators predicted that Dodd-Frank's bounty provision would result in an increase in reporting, and that seems to have borne out, though the increase has been small. Some worry that the incentives provided by Dodd-Frank's bounty provision will undermine internal compliance procedures required under Sarbanes-Oxley by encouraging employees to report violations directly to the SEC rather than to an internal compliance department.

Dodd-Frank's Anti-Retaliation Provisions

In 2011, a number of federal district courts attempted to clarify the precise protections offered to whistleblowers under the Dodd-Frank Act. In one of the more comprehensive cases, the Southern District of New York considered alleged violations of the Dodd-Frank Act, the Securities Exchange Act of 1934, and Delaware law. *See Egan v. TradingScreen, Inc.*, No. 10 Civ. 8202, 2011 U.S. Dist. LEXIS 47713 (S.D.N.Y. May 4, 2011). Egan brought numerous claims alleging violations of Dodd-Frank, the Securities Exchange Act of 1934 (the Exchange Act), and Delaware law. In deciding the defendants' motions to dismiss, the Southern District of New York addressed the question of whether Dodd-Frank's anti-retaliation provisions require disclosure to the SEC. The *Egan* court also considered whether it is sufficient under Dodd-Frank that information provided to attorneys retained by independent directors was ultimately reported to the SEC rather than being directly communicated to the SEC.

In assessing the first issue, the court noted that Dodd-Frank's anti-retaliation provisions explicitly prohibit retaliation against individuals providing information to the SEC. The provisions also protect informants who make disclosures in one of four other categories: disclosures required or protected under (1) Sarbanes-Oxley, (2) the Exchange Act, (3) 18 U.S.C 1513(e), and (4) any other law, rule, or regulation subject to the SEC's jurisdiction. On its face, the statute does not require that these disclosures be made directly to the SEC. The court looked to the legislative history of Dodd-Frank, and found that while no congressional discussions focused on whether reporting to the SEC is a requirement for anti-retaliation protection, other provisions suggest that Congress could have extended protection to persons other than those reporting to the SEC had it so desired. In the absence of a broadly worded protection, the court found that Congress intended to encourage reporting to the SEC and that to endorse Egan's interpretation would completely eviscerate the phrase "the Commission" from the statute's definition of whistleblower.

The court in *Egan* ultimately found that the four additional categories of covered disclosures were intended to be narrow exceptions to the statute's overall definition which limits a whistleblower to one reporting directly to the SEC. Therefore, to be successful in a Dodd-Frank whistleblower claim, an individual must allege that he or she reported information to the SEC, or that the disclosures fell into one of the four other categories not requiring reporting to the SEC. Although Egan alleged his disclosures were protected by section 806 of Sarbanes-Oxley, because his employer was privately held, this section did not apply. Because Egan did not make disclosures protected under Sarbanes-Oxley, Dodd-Frank's anti-retaliation provisions offered no protection on that basis.

The plaintiff in *Egan* also argued that even if Dodd-Frank required reporting to the SEC, the whistleblower provisions of the act still protected him because he acted jointly with outside attorneys retained by independent directors to reveal the wrongdoing. Egan alleged that he expected the attorneys to report the information to the SEC, which they did. The court found that while Egan did not allege that he was a substantial source of information, that he hired the attorneys, or that he directed their actions, he still adequately pled that he acted jointly with the attorneys and others in investigating the wrongdoing. Under a plain reading of Dodd-Frank, the individual invoking a private right of action need not have led the investigative and reporting efforts, rather he must at least have acted with others in the reporting.

Lastly, the *Egan* court considered whether the reporting must be made directly to the SEC in order to invoke Dodd-Frank's anti-retaliation protections. The court held that while reporting directly to the SEC is a requirement of Dodd-Frank's bounty provisions, it is not a pre-requisite to a private right of action under the anti-retaliation provisions.

Another case from 2011 demonstrates what may soon become commonplace—asserting whistleblower protection under both Sarbanes-Oxley and Dodd-Frank. In *Hudes v. Aetna Life Insurance Co.*, No. 10-1444, 2011 U.S. Dist. LEXIS 97426 (D.D.C. Aug. 30, 2011), plaintiff Hudes alleged that her employer—the World Bank—violated both the Sarbanes-Oxley Act and the Dodd-Frank Act (among others) by retaliating against her for reporting corruption and securities law violations to the World Bank's audit committee and United States congressional committees which oversee the bank. Hudes alleged that the World Bank violated Sarbanes-Oxley by refusing to reinstate her and by barring her from the bank's premises. She also claimed entitlement to protection under both Sarbanes-Oxley and Dodd-Frank as a "gatekeeper attorney."

The World Bank successfully argued that it was not subject to Sarbanes-Oxley because it is not a "company" for the purposes of the whistleblower provision. This provision applies only to companies with a class of securities registered under the Exchange Act or required to file reports under that act. The court noted that pursuant to 22 U.S.C. § 286k-1(a), the World Bank's securities are explicitly deemed exempt under the Securities Act and the Exchange Act. Since these provisions do not apply to the World Bank, it is not a "company" subject to the whistleblower protections of Sarbanes-Oxley.

Hudes also attempted to claim that Dodd-Frank allowed the filing of Sarbanes-Oxley claims directly in a United States District Court, without first having to exhaust administrative remedies. From a jurisdictional standpoint, the court found that because Hudes's Sarbanes-Oxley claim failed regardless of exhaustion of administrative remedies, it would not matter if Dodd-Frank expanded jurisdiction. On a substantive level, the court was not persuaded by Hudes' invocation of Dodd-Frank, noting that the only section Hudes actually cited was the bounty provision, which requires that the whistleblower provide information after July 21, 2010—later than the date Hudes alleged. Even if she had reported the alleged illegal activities after July 21, 2010, the court lacked jurisdiction over Hudes' bounty provision claims because such determinations are to be made by the SEC with a direct right of appeal to a federal appellate court.

Sarbanes-Oxley's Whistleblower Protections

Though Sarbanes-Oxley will be a decade old this year, courts are still deciding exactly whom its provisions protect. In 2011, the United States Court of Appeals for the Ninth Circuit considered to whom informants must make statements for Sarbanes-Oxley's anti-retaliation provisions to apply. *See Tides v. Boeing Co.*, 644 F.3d 809 (9th Cir. 2011). Plaintiffs Matthew Neumann and Nicholas Tides were employees of Boeing's

IT Sarbanes-Oxley Audit Group which annually assessed the effectiveness of the company's internal controls and procedures for financial reporting. Tides and Neumann perceived deficiencies in the audit practices, which they thought could be in violation of Sarbanes-Oxley. After a newspaper reporter contacted Tides and Neumann about an article she was writing on Boeing's Sarbanes-Oxley compliance, both recounted their fears to the reporter and forwarded work e-mails to her. Boeing terminated Tides and Neumann for violating company policies on communicating with the media.

Upon termination, Neumann and Tides separately filed Sarbanes-Oxley whistleblower complaints with the Occupation Safety and Health Administration, which issued each a right-to-proceed letter. After consolidating their cases, the district court granted summary judgment in favor of Boeing. On appeal, the Ninth Circuit assessed whether communications to a reporter constituted protected activity under section 1514A of Sarbanes-Oxley, concluding that they were not. The court emphasized that the plain language of the statute provides protection only when information or assistance is provided to a federal agency, a member of Congress or a congressional committee, or a supervisor of the employee. Plaintiffs nevertheless urged that Sarbanes-Oxley protected their disclosures because reports to the media may eventually cause information to be provided to Congress or federal agencies. The court rejected this interpretation, stating that if adopted by the court plaintiffs' interpretation had the potential to bring virtually any disclosure under the ambit of the law.

No doubt much litigation to clarify Dodd-Frank's whistleblowing provisions is still in the offing. Decisions from 2011 demonstrate how courts might rule in these cases and how they view the interaction between Sarbanes-Oxley and Dodd-Frank. As *Tides* shows, Dodd-Frank does not replace Sarbanes-Oxley for individuals seeking protection from retaliation for whistleblowing. Rather, Dodd-Frank supplements the earlier act by expanding the types of disclosures protected and encouraging disclosure through the promise of a reward. As seen in *Egan* and *Hudes*, it is clear that Dodd-Frank does not alter Sarbanes-Oxley's requirements as to who is subject to its jurisdiction. However, it remains to be seen whether individuals will be able to successfully assert that Dodd-Frank expands the federal courts' jurisdiction over Sarbanes-Oxley claims.

Retroactive Application of Dodd-Frank

As new legislation, there will for the foreseeable future be claims brought under Dodd-Frank for incidents occurring before the act's passage as litigants determine its applicability. In June 2011, the United States District Court for the Northern District of California addressed an important question regarding the retroactive application of section 929M of Dodd-Frank, which authorizes the SEC to bring claims for aiding and abetting violations of the Investment Company Act (ICA) in federal court. *See SEC v. Daifotis*, No. 11-00137, 2011 U.S. Dist. LEXIS 60226 (N.D. Cal. June 6, 2011).

Dodd-Frank amended the ICA to provide that "[f]or purposes of any action brought by the Commission . . . any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this Act, or of any rule or regulation issued under this Act, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." *SEC v. Daifotis* at *32 (citing Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1861–62 (2010)). Relying on this provision, the SEC argued that defendants Daifotis and Merk had aided and abetted violations of sections 13(a) and 34(b) of the ICA. Section 13(a) prohibits a registered investment company from changing its subclassification, borrowing money, deviating from its policy regarding concentration of investments, and changing the nature of its business and ceasing to be an investment company without the approval of a majority of outstanding voting securities. Section 34(b) makes unlawful the making of untrue material statements and the omission of material facts in registration statements, applications, reports, accounts, records, or other documents required by the ICA to be kept or filed.

The court found that the SEC's reading of the statute resulted in the impermissible retroactive application of the law, as the SEC did not already have the authority to prosecute such violations via administrative proceedings. The court highlighted testimony by the SEC chairman stating that the Dodd-Frank Act created new authority to bring such claims. The court also noted that all cited examples of the SEC's authority in this realm were orders entered into with the consent of the individuals at issue. The court ultimately found that Dodd-Frank increased liability, imposed new duties, and would impair rights if applied retroactively, and that it created new jurisdiction. Because of these factors, section 929M of Dodd-Frank should not be applied retroactively.

These cases offer just a preview of what we might expect in 2012 as courts further engage with Dodd-Frank's provisions. Given a renewed focus on corporate fraud, more whistleblower claims are likely to arise in 2012. It remains to be seen whether fears that Dodd-Frank's bounty provisions will lead to a decrease in internal reporting are well-founded, though if individuals wish to claim protection under both statutes, this may be an unfounded concern. There is little doubt that 2012 will be an interesting year in securities law as courts try to clarify Dodd-Frank's meaning and application.

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