BOARDMEMBER.com

Opening the Floodgates: The Dodd-Frank Whistleblower Provisions' Impact on Corporate America

by Doug Clark, Wilson Sonsini Goodrich & Rosati

During *Corporate Board Member* and NYSE Euronext's Annual Boardroom Summit audit committee peer exchange, the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) excited discussion and concern. That's not surprising, as a fair amount of government activity focused on Dodd-Frank is presently in the works. In October, the Securities and Exchange Commission (SEC) will report to Congress concerning its whistleblower bounty program, as well as the establishment of its own whistleblower office. In November, the SEC will propose rules to establish a Whistleblower Incentives and Protection Program and will appoint the head of the new whistleblower office. That sound you hear is the sound of our government growing.[1]

The corporate world should watch the evolution of this bounty program closely. To help set these developments in context, this article provides some background and thoughts about the future.

A Short Summary: Dodd-Frank requires the SEC, in any action in which it levies sanctions in excess of $1 million, to compensate whistleblowers who provide original information with between 10 to 30 percent of the amount of the sanctions. [2]

Is This New News? Part I: Kind of. The SEC actually has had a bounty program in place for more than 20 years. This original bounty program rewarded whistleblowers for information leading to the recovery of a civil penalty from an insider trader, a tipper, or someone who controlled an insider trader. The bounty was limited to 10 percent of a civil penalty exacted pursuant to a court order. The decision to award a bounty, and to whom, was within the sole discretion of the SEC (as it will be under Dodd-Frank).

This bounty program was a fairly well-kept secret, as the Office of Inspector General (OIG) noted in a March 29, 2010, report: "[T]he Commission has not received a large number of applications from individuals seeking a bounty over this 20-year period. We also found that the program is not widely recognized inside or outside the Commission." [3]

In fact, the OIG determined that between 1989 and 2009, the SEC had paid a total of seven bounties to five claimants amounting to less than $160,000 and had denied five bounty applications. Consequently, the OIG made a number of recommendations to improve the bounty program, including coming up with a communication plan to raise the profile of the program, posting an application form on the SEC website, and developing specific criteria for awarding a bounty. The OIG also suggested that the SEC incorporate best practices from more successful Department of Justice (DOJ) and Internal Revenue Service (IRS) bounty programs, both of which are discussed below.

For purposes of this discussion, the old bounty program is just an interesting reference point. The Dodd-Frank mandate to the SEC is broader and more lucrative for whistleblowers. The Whistleblower Incentive and Protection Program to be implemented by the SEC will not be limited to insider trading and will not cap bounties at 10% of a civil penalty. It's also apparent that the new bounty program will not be a secret inside or outside the Commission.

Is This New News? Part II: Anyone outraged at the concept of our government paying whistleblowers for reporting unlawful activity might be surprised to find out that it's been going on for a quite a while and that it's a big, lucrative business. Two federal bounty programs stand out and are worthy of discussion.

The False Claims Act

The False Claims Act, 31 U.S.C. § 3729, et seq., generally creates liability for persons who make false claims to or defraud the government in order to receive money from the government. For example, a defense contractor who knowingly submits a false invoice to the government for payment would run afoul of this act. Section 3730 permits a whistleblower – called a relator in False Claims Act jargon – to bring an action for the government. The procedure for initiating and maintaining such an action, called a qui tam action, is complex and beyond the scope of this article. Where the government proceeds with an action brought by a whistleblower, the whistleblower is entitled to at least 15 percent and up to 25 percent of the proceeds of an award or a settlement. If the government declines to proceed with the case and the relator proceeds with it and obtains a recovery, the whistleblower is eligible for a higher percentage.

The False Claims Act, once known as the "Lincoln Law" was enacted in 1863 to address government contracting fraud during the Civil War. It was substantially amended most recently in 1986 (note that the old SEC bounty program went into effect in 1989). Since 1986, according to DOJ statistics, qui tam lawsuits have returned more than $15 billion to the government and have generated $2.5 billion in awards to whistleblowers. That's real money, and it has attracted real plaintiff law firms to represent whistleblowers in qui tam actions. Needless to say, the SEC's old bounty program did not spawn a thriving plaintiffs' bar.

Early indications are that the plaintiffs' securities class action and qui tam bar are acutely interested in the Dodd-Frank whistleblower provision. For example, one of the leading False Claims Act plaintiffs' firms has created a portion of its website for this opportunity, as I'm sure others have.[4] In addition, a reference to the Dodd-Frank whistleblower provision has worked its way into the standard press releases seeking plaintiffs for securities class actions. One does not have to be an economist to see the direction in which this is heading. Plaintiffs' lawyers follow the money, and they smell money in this new law.

Tax Fraud Cases

In 2006, the IRS seriously entered the whistleblower field with the passage of the Tax Relief and Health Act of 2006. The whistleblower provisions of that act offer a bounty to those who provide the IRS with information about tax underpayments of $2 million or more, with whistleblowers eligible for up to 15 to 30 percent of the amount recovered by the IRS. The program is young, but statistics for 2008 are illustrative of the kind of traction a whistleblower program can get in its early days: In that year alone, the IRS received 476 whistleblower complaints alleging tax underpayment by 1,246 taxpayers. It's not clear how much money whistleblowers yielded from those complaints.[5]

It is not beyond belief that the whistleblower office the SEC will give birth to this month will administer a program that could generate a similar or greater number of complaints. The impact on the SEC's Enforcement Division and Corporate America will be tremendous. More on that below.

What About My Hotline?: The Sarbanes-Oxley Act of 2002, passed in reaction to the spate of corporate scandals (Enron, Worldcom) that preceded the spate of corporate scandals that spawned Dodd-Frank (Countrywide, Bear Stearns, Lehman Brothers), required public company audit committees to establish procedures for "confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."[6] Public companies faithfully complied, and it became a routine part of audit committees' lives to review, examine, and investigate anonymous complaints. Most companies set up a hotline that employees could use to report potentially fraudulent activity.

This provision of Sarbanes-Oxley worked. Employees registered complaints and Audit Committees considered them and, in many instances, retained counsel and experts to investigate them. Companies did not set up bounties, however, and are poorly positioned to compete with the SEC's promise of a 15 to 25 percent cut of any potential fine. Let's say you were a well-intentioned employee of a publicly listed company and are distressed when you learn that high-ranking employees at your company are bribing government officials in foreign countries. Do you call the audit committee hotline and sleep the sleep of the righteous? Or do you contact the SEC's brand spanking new whistleblower office and, perhaps someday, sleep in Gstaad after a day on the slopes? In 2008, the SEC reached a settlement with Siemens AG for violations of the Foreign Corrupt Practices Act (FCPA) and obtained a $350 million disgorgement of profits. Feel free to pause and do the arithmetic. It is not unreasonable to assume that the Dodd-Frank whistleblower provisions will largely render moot the Sarbanes-Oxley audit committee procedures.

FCPA—Where the Real Money Is: Having mentioned the FCPA anecdotally, it's appropriate to bring the point home. Pursuant to the FCPA's anti-bribery provisions, it is unlawful for any issuer, domestic concern, or person acting in the United States to offer anything of value to members of a foreign government, international organization, or political party for the purpose of: (1) influencing duties; (2) inducing them to use their influence to affect a foreign government's or agency's decision; (3) obtaining or retaining business for anyone; or (4) directing business to anyone. Fines and penalties for violating the FCPA tend to be higher than fines for violations of other aspects of the securities laws. The reason for that is simple: The fines are driven by the profits a company makes by virtue of the wrongful conduct. The SEC has made it clear through its public statements that it intends to focus on investigating and taking action on violations of the FCPA. More importantly, the SEC has made the point clear through its enforcement program. In 2010 alone, the SEC concluded 12 FCPA investigations and assessed monetary penalties totaling more than $360 million.

Putting aside the Goldman Sachs settlement of $550 million this year for alleged unlawful activity relating to the financial crisis, these numbers are staggering compared to standard SEC settlements. Settlements in more typical SEC enforcement matters relating to insider trading and false financial reporting this year ranged from $20,000 to $28 million. While whistleblower activity under the new regulatory regime will be robust in all areas, the FCPA will be the belle of the ball.

You Can Be a Whistleblower: So can I. Anyone can. Renowned Enron whistleblower Sherron Watkins was an Enron employee and perhaps that created a perception that whistleblowers and corporate employees are one and the same. That's not an accurate association, however. Dodd-Frank defines whistleblower as follows: "any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission."[7] This is drafted broadly enough to encompass, for example, forensic accountants poring through public filings for perceived inaccuracies. Could a competitor or customer become a whistleblower? Sure. Anyone can be a whistleblower, assuming they can dredge up information or an analysis indicating a violation of the securities laws.

Obvious Statements about the Future: Although the SEC has work to do to flesh out the Dodd-Frank whistleblower provisions, for the first time the agency has the benefit of a significant incentive program for people to identify corporate wrongdoing. The infrastructure and rules the SEC puts in place to implement the law will be modeled after the successful DOJ and IRS bounty programs. There will be hundreds of whistleblower complaints to the SEC annually, and the Division of Enforcement and the new whistleblower office will be under a severe burden to handle them all. Numerous investigations will ensue, prompting companies to respond to the SEC investigations and, in some cases, initiate audit committee investigations about the allegations. Follow-on class and stockholder derivative actions may be filed in reaction to SEC investigations.

Lastly, at some point in the next year or so, it is quite likely that the SEC will announce a substantial bounty payment arising from the Dodd-Frank whistleblower initiative. Then, the floodgates will truly open.

[1] See www.sec.gov for more information about the SEC's Dodd-Frank implementation program and rulemaking/comment process.
[2] To see the Dodd-Frank text, go to http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/content-detail.html.
[3] See http://www.treas.gov/tigta/auditreports/2006reports/200630092fr.pdf.
[4] See http://www.phillipsandcohen.com/CM/Custom/Whistleblowers-for-SEC.asp.
[5] http://www.irs.gov/pub/whistleblower/annual_report_to_congress_september_2009.pdf
[6] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 §301, 116 Stat. 776 (2002)
[7] http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/content-detail.html

This article first appeared on boardmember.com on October 28, 2010, and is used with the permission of Corporate Board Member and NYSE Euronext.