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Potential Circuit Split Creates an Uncertain Future for Whistleblower Protection of Internal Reporting

Asadi v. G.E. Energy (USA), LLC, (5th Cir. Jul. 17, 2013) *versus Murray v. UBS Securities, LLC and UBS AG,* (S.D.N.Y. May 21, 2013)

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The Dodd-Frank Whistleblower Program

The Dodd-Frank Act amended the Securities Exchange Act of 1934 by creating protections and rewards for anyone who provides information that helps the SEC in enforcing the law.[1] Section 922 directs the SEC to provide monetary awards, ranging from 10 percent to 30 percent of the monetary sanctions collected, to individuals who voluntarily provide original information that leads to SEC enforcement actions resulting in sanctions in excess of US$1 million. The Office of the Whistleblower Program ("OWP") was established to administer this new program, using regulations put in place by the SEC as of August 2011.[2]

In fiscal year 2012, the first full year of OWP operation, 3,001 tips and complaints were received, mostly relating to corporate disclosures and financial statements as well as fraud relating to securities offerings, from 49 countries and all 50 states.[3]

As tips and complaints begin to add up and the number of enforcement actions increases, the number of monetary awards to whistleblowers probably will rise and this will likely encourage more whistles to be blown. As a corollary, suits by whistleblowers against current and former employers alleging adverse employment decisions as retaliation for whistleblowing will also likely increase. Anti-retaliation suits raise concerns for the whistleblowers, the employers and the SEC. As the OWP Chief has noted, "Quality

1 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203 § 922, 124 Stat. 1376, 1841 (2010) (entitled "Securities Whistleblower Incentives and Protection."). The statute provides, in relevant part: "[n]o employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower—(i) in providing information to the Commission in accordance with this section; (ii) in initiating, testifying in, or assisting in any investigation or judicial or administrative action of the Commission based upon or related to such information; or (iii) in making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.), this chapter, including section 78j-1(m) of this title, section 1513(e) of Title 18, and any other law, rule, or regulation subject to the jurisdiction of the Commission." 15 U.S.C. § 78u-6(h)(1)(A).

2 SEC Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 113, 34300, Release No. 34-64545 (Jun.13, 2011). This is Final Regulation 21F, effective as of August 12, 2011, which defines terms under the whistleblower provisions, establishes procedures for applying for awards, lays out criteria for award determinations and, importantly, implements the anti-retaliation provisions of Dodd-Frank.

3 SEC Annual Report on the Dodd-Frank Whistleblower Program, Fiscal Year 2012, at 4-5, *available at* http://www.sec.gov/about/offices/owb/annual-report-2012.pdf. Appendix A of the Annual Report shows that complaints relating to "Corporate Disclosures and Financials" represented 18.2% of the total tips received, followed by 15.5% relating to "Offering Fraud" and 15.2% relating to "Manipulation." Appendix B provides information on which states the complaints originated from, mostly the populous states, including California (17.4%), New York (9.8%), Florida (8.1%), and Texas (6.3%). Of the international complaints, 74 were from the United Kingdom, 46 from Canada, 33 from India, and 27 from China.

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information is the lifeblood of the [SEC whistleblower] program. If people think if they report wrongdoing they get fired or risk other retaliation, that well will dry up quickly."[4]

Now, a circuit split is looming as to whether individuals who report internally, **before** going to the SEC, can be protected by the anti-retaliation provisions. Just last week, the Fifth Circuit dismissed an anti-retaliation claim in which the employee reported suspected wrongdoing to his supervisor, not the SEC, finding that such an individual was not a "whistleblower" under the Act because that definition required reporting to the SEC. That decision is in direct conflict with last month's New York federal district court holding that the anti-retaliation provisions **do** apply to individuals who report internally, rather than to the SEC. The New York decision was the fifth in a line of district courts (involving courts in the Second, Sixth and Tenth Circuits) that have all refused to dismiss anti-retaliation claims on the ground that disclosure internally can render an employee protected under the anti-retaliation protections.[5] *Asadi v. G.E. Energy (USA), LLC* and *Murray v. UBS Securities, LLC and UBS AG* analyzed the whistleblower-protection provision of Dodd-Frank and the application of the SEC's Final Regulation 21F.

Asadi: Limiting the Anti-Retaliation Protections to Those Reporting to the SEC

Khaled Asadi sued his former employer alleging a violation of the Whistleblower Incentives and Protection provision of Dodd-Frank. Asadi was the Iraq Country Executive for G.E. Energy. Upon being informed that G.E. had hired a woman closely affiliated with a senior Iraqi official to influence the negotiation of a lucrative joint venture agreement, Asadi reported this information to his supervisor and an ombudsperson for fear that this activity violated the Foreign Corrupt Practices Act. He was then given a surprisingly negative review and was pressured to step down. When he did not, he was fired. Asadi sued, alleging that his termination after an internal report of possible securities law violations (relating to potential FCPA issues) violated the whistleblower-protection provision of Dodd-Frank which states that "no employer may discharge…or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower."[6]

The Southern District of Texas dismissed Asadi's claim, holding that the whistleblower protection provision does not extend to extraterritorial whistleblowing activity and declined to reach the issue of whether Asadi qualified as a whistleblower because he reported internally instead of to the SEC. Last week, the Fifth Circuit affirmed the dismissal, but on the grounds that Asadi did not qualify as a whistleblower.[7]

Asadi argued that while he was not a whistleblower as defined by Section 78u-6(a)(6)[8], he should qualify for protection because his actions fell under Section 78u-6(h)(1)(A)(iii), which protects certain internal disclosures to supervisors required under Sarbanes-Oxley. The court conceded that the SEC's final regulation on the issue and various district courts agreed with his view. However, Judge Elrod held that the plain language of the whistleblower protection provision created a private cause of action **only** for individuals who provide information relating to a violation of the securities laws **to the SEC**.

The court rejected the prior decisions of other courts, finding that they had misread Section 78u-6. Applying canons of statutory interpretation, Judge Elrod found that the anti-retaliation provision should be read such that it applies, first and foremost, to certain protected individuals, namely, those who are "whistleblowers" under Section 78u-6(a) because they reported to the SEC, and only then does the provision lay out certain activities taken by those protected individuals that are entitled to protection. Thus, only whistleblowers as defined by the Act are entitled to protection under Section 78u-6(h)[9]. The court used the following example to illustrate how internal reporting under Section 78u-6(h)(1)(A)(iii) would only apply to those considered "whistleblowers": Suppose an employee reported suspected wrongdoing to his supervisor

4 Cheryl Soltis Martel, SEC Whistleblower Office Preps for Additional Tips, Aug. 24, 2012, *available at* http://www.directorship.com/sec-whistleblower-office-preps-for-additional-tips/.

5 Judge Furman's ruling follows the lead of district judges in Colorado, Connecticut, Tennessee and a fellow judge in the S.D.N.Y. *See Genberg v. Porter*, 2013 WL 1222056, at *10 (D. Col. Mar. 25, 2013); *Kramer v. Trans-Lux Corp.*, 2012 WL 4444820, at *3-5 (D. Conn. Sept. 25, 2012); *Nollner v. S. Baptist Convention*, Inc., 852 F. Supp. 2d 986, 993-95 (M.D. Tenn. 2012); *Egan v. Tradingscreen*, Inc., 2011 WL 1672066, at *5 (S.D.N.Y. May 4, 2011).

6 15 U.S.C. § 78u-6(h)(1)(A).

7 The 5th Circuit did not address the extraterritoriality issue, instead stating that the court may affirm an order granting a motion to dismiss for failure to state a claim "on any basis supported by the record." *Asadi v. G.E. Energy (USA), LLC*, 2013 WL 3742492, at *1 (5th Cir. Jul. 17, 2013).

8 15 U.S.C. § 78u-6(a)(6) defines "whistleblower" as "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."

9 In a somewhat bizarre digression, the Court attempted to shore up its analysis by arguing that if the provision was to be read the way Asadi wanted, the anti-retaliation provisions under Sarbanes-Oxley would be rendered moot as an employee would have the option of bringing both Sarbanes-Oxley and Dodd-Frank anti-retaliation claims, but that an individual would choose to raise Dodd-Frank claims over Sarbanes-Oxley. The Court thought this was so because Dodd-Frank allows for greater monetary recovery, does not require an initial claim filed with an agency before bringing a claim in federal court, and has a longer statute of limitations.

and the SEC on the same day but was immediately fired, before the supervisor could know about the report to the SEC. In that case, the employee is a whistleblower because he reported to the SEC, but would not be able to assert a retaliation claim on the first two grounds set forth in Section 78-6(h)(1)(A) because he would not be able to show that he was terminated *because of* his report to the SEC. The employee would, nonetheless, be protected under the third category in that section and could set forth a retaliation claim on the ground that he suffered retaliation for his internal disclosure.

Only at the end of the decision did the Court take up the SEC's Final Regulation 21F, to be explained further below. In the Court's view, the SEC regulation had redefined "whistleblower" and broadened it to include those who have taken the actions listed in Section 78u-6(h)(1)(A). This redefinition, according to Judge Elrod, flew in the face of Congress' unambiguous definition of the term and required rejection of the SEC's interpretation.[10]

Murray: Extending the Anti-Retaliation Protections to Internal Reporting

Like Asadi, Trevor Murray also sued his former employer for allegedly violating the anti-retaliation provision. Murray was a Senior Commercial Mortgage-Backed Security Strategist for UBS, responsible for researching and preparing reports about UBS's CMBS products. He complained to supervisors that others at UBS were influencing his reports and pressuring him to draft reports that were more favorable to UBS and in keeping with what the business line wanted regarding the lucrative mortgage-backed securities market. Shortly thereafter, he was terminated even though he had received a positive review. He claimed that his termination violated the anti-retaliation provision.

UBS moved to dismiss the claim arguing that because Murray made reports to his supervisors, not the SEC, he could not be considered a whistleblower under the statute. The Dodd-Frank definition of whistleblower, UBS AG argued, limits the term to those who provide to the SEC information relating to a violation of the securities laws.

In denying the motion to dismiss, the Court reasoned that to obtain protection under the anti-retaliation provisions, a plaintiff must show *either* that he provided information to the SEC or that his disclosures fell under categories set forth in the anti-retaliation provision, the last of which includes disclosures to supervisors under Sarbanes-Oxley. Significantly, the Court also found that Final Regulation 21F resolved an ambiguity in the statute by granting whistleblower status to individuals who report securities laws violations to persons other than the SEC.[11] The regulation provides that "for purposes of the anti-retaliation protections [under Section 78u-6(h)(1)], you are a whistleblower if…you provide that information in a manner described in [the list in Dodd-Frank which includes information provided to an employer under Sarbanes-Oxley]." SEC comments to Final Regulation 21F expressly noted that the anti-retaliation protections would apply to three categories of whistleblowers, the third of which includes individuals who report to persons other than the SEC.[12]

Looking Forward: Impacts on Clients

So now we have the Fifth Circuit on the one hand, finding no ambiguity or conflict within Dodd-Frank and interpreting the anti-retaliation provision to narrowly apply to only those individuals who report to the SEC, and five district courts around the country on the other hand, who have found the statute ambiguous and have applied the SEC's Final Regulation 21F to resolve that ambiguity in favor of individuals who report internally. We are likely to see appeals from those district court cases that could lead to a circuit split which would be prime for Supreme Court review.

The Fifth Circuit decision seems to fall squarely on the side of the employers, in that it limits those who might bring anti-retaliation claims. There are those, then, who would claim victory for employers. However, that decision also incentivizes employees to go to the SEC directly, bypassing any internal reporting they might have done and denying companies the chance to correct suspected wrongdoing internally before being investigated by the SEC. Additionally, we are facing an uncertain legal landscape on this issue. As of yet, we do not know how those five district decisions will fare on appeal, and it could be that the 5th Circuit's opinion becomes the minority view.

In spite of that, these cases point to the same conclusion: However the legal landscape shapes up over the coming months and years, companies should be doing what they can to limit anti-retaliation claims they will have to defend and to encourage employees suspicious of wrongdoing to whistleblow internally.

10 As of yet, Asadi has not petitioned for rehearing or rehearing en banc but has fourteen days from the date of the judgment (July 17) to do so. Asadi also has until October 17 to petition the Supreme Court for certiorari.

11 The court noted that the statute was ambiguous, in that the whistleblower definition narrowly limited the term to one who discloses to the SEC whereas the anti-retaliation provisions were broader in scope by including persons who disclosed to persons other than the SEC, and Congress's intent in reconciling those provisions was unclear.

12 Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34300, 34304 (Jun. 13, 2011) [hereinafter Final Rule 21F]: "The second prong of the Rule 21F-2(b)(1) standard provides that, for purposes of the anti-retaliation protections, an individual must provide the information in a manner described in Section 21F(h)(1)(A). This change to the rule reflects the fact that the statutory anti-retaliation protections apply to three difference categories of whistleblowers, and the third category includes individuals who report to persons or governmental authorities *other than the Commission*." (emphasis in original)

Since we don't know which way the Supreme Court would rule on this issue, one should not assume that employees will not be able to bring anti-retaliation claims if they report internally.

For instance, *Murray* could be seen as incentivizing employees to go "up the chain" before going to the SEC, thereby giving companies the opportunity to deal internally with issues before being embroiled in an investigation by the SEC. Thus, *Murray* may strengthen corporate codes of conduct that encourage or require employees to report issues internally as a first step. The ruling also is in line with Regulation 21F in which the SEC encourages whistleblowers to use internal compliance processes. First, if a whistleblower reports internally, that whistleblower has 120 days to report to the SEC, and if that deadline is met, the whistleblower is given the benefit of the earlier date for "first in line" purposes to determine potential rewards, **and** the whistleblower receives the benefit of any information collected from the internal investigation, which might increase the potential award.[13] Second, the fourth factor listed by the SEC that will increase an award is whether the whistleblower participated in, and assisted, an internal compliance process.[14] Indeed, obstructing an internal compliance process is grounds for decreasing the amount of an award.[15]

On the other hand, *Asadi* and *Murray* highlight the complicated dance that now surrounds how companies maintain a healthy and cooperative compliance culture while managing employee performance. Sarbanes-Oxley creates a web of compliance-related disclosure obligations on top of existing obligations that arise under the 1934 Act. Until the disagreement between *Asadi* and *Murray* is resolved, should an employee raise a disclosure issue, a compliance breakdown issue or a disagreement with the content of a company's disclosure, that may now raise a potential whistleblower issue to the extent that employee subsequently experiences a pay cut, fails to receive a promotion or is laid off.

Either way the law develops, companies should improve internal systems for documenting employee-raised issues and how they are handled. Process will be important, including building a record showing that employee concerns are taken seriously and considered by an appropriate person. In addition, internal compliance programs need to be reviewed and re-designed if necessary to encourage employees to use them. This also will involve changes in training and communication to make sure employees know the rules and processes. Finally, *Murray* and Regulation 21F highlight the need for companies to review their evaluation, promotion and exiting procedures to make sure that managers know how to deal with employees who have raised disclosure-related issues. Again, these functions must now consider how communications are handled with an employee who must be viewed as a potential whistleblower. In a retaliation case, the burden is on the company to show a non-discriminatory basis for the adverse employment decision.[16] Being able to point toward an evaluation process that is well-designed, consistent and accurate will be of help in shouldering this burden.

Regardless of how the law on whistleblower anti-retaliation claims develops, the goal for employers should be the development of the strongest compliance cultures, processes and codes of conduct possible to create effective, trustworthy and transparent compliance programs that encourage internal reporting, without any fear of retaliation.

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13 *See* Final Rule 21F-4(7), ("If you provide information to…an entity's internal whistleblower, legal, or compliance procedures for reporting allegations of possible violations of law, and you, within 120 days, submit the same information to the Commission….as you must do in order for you to be eligible to be considered for an award, then, for purposes of evaluating your claim to an award….the Commission will consider that you provided information as of the date of your original disclosure, report or submission to one of these other authorities or person.")

14 In a video guide for potential whistleblowers, the OWP explains the main factors looked at in determining whether to award the whistleblower and how much that award should be. SEC Transcript, What Happens to Tips, *available at* http://www.sec.gov/about/offices/owb/owb-what-happens-to-tips.shtml. The video cites to Final Rule 21F-6(a)(4): "Participation in internal compliance systems. The Commission will assess whether, and to the extent to which, the whistleblower and any legal representative of the whistleblower participated in internal compliance systems. In considering this factor, the Commission may take into account, among other things: (i) Whether, and to the extent to which, a whistleblower reported the possible securities violations through internal whistleblower, legal or compliance procedures before, or at the same time as, reporting them to the Commission; and (ii) whether, and to the extent to which, a whistleblower assisted any internal investigation or inquiry concerning the reported securities violations."

15 *See* Final Rule 21F-6(b)(3).

16 *See McDonnell Douglas Corp. v. Green*, 411 U.S. 792, 802-03 (1973). The burden is not light: To prevail in a Sarbanes-Oxley retaliation case, the employer needs to show by clear and convincing evidence that they would have taken the same adverse employment action in the absence of the protected action by the former employee. S*ee Bechtel v. Admin. Review Board*, 710 F.3d 443, 447 (2d Cir. 2013).

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