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Unwitting Blow To Internal Corporate Compliance Programs

Law360, New York (August 08, 2013, 7:07 PM ET) -- Despite a string of earlier district court decisions holding that the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 protected not only whistleblowers who reported violations of the nation's securities law to the U.S. Securities and Exchange Commission but also those who reported such violations only to their employers, the Fifth Circuit recently held that the law provides no protection to employees who report only internally.

The harm that the court's decision in Asadi v. GE Energy (USA) LLC does to whistleblowers is obvious since it limits the circumstances under which they are protected by the anti-retaliation provisions of the Dodd-Frank Act. But by limiting the law's protections in this way, the Fifth Circuit's ruling will also weaken the internal compliance programs that the Sarbanes-Oxley Act has mandated for publicly traded companies since its enactment in 2002.

With a clear message from the Fifth Circuit that they can find no protection from the courts for internal whistleblowing, many would-be whistleblowers are likely to pass up whistleblower "hot lines" and other such avenues that would alert their employers to violations of securities laws and allow them to address the violations.

These employees are now more likely to run directly to the SEC, both because they may be eligible for monetary awards under the commission's new whistleblower program and because they will have less protection for making internal reports. The irony in this outcome is that it undermines a delicate balance between competing interests that the SEC achieved in the rules that it issued in 2011 for the whistleblower-award or "bounty" program established by Dodd-Frank.

The Asadi case unfolded in Iraq in 2010, when Iraqi officials informed Khaled Asadi, the Iraq country executive for GE Energy, that the company may have hired a woman closely associated with a senior Iraqi official in order to gain advantage in negotiating a lucrative contract.

Concerned that this conduct violated the Foreign Corrupt Practices Act (parts of which are incorporated into U.S. securities laws), Asadi relayed the information to his supervisor and a company ombudsperson but did not report the matter to the SEC. Over the next year, the company progressively took greater adverse actions against Asadi, culminating in his termination.

Asadi filed suit under the Dodd-Frank Act's whistleblower-protection provision, 15 U.S.C. § 78u-6(h), which prohibits retaliation against a "whistleblower" who engages in certain protected activity. The district court dismissed Asadi's Dodd-Frank claim, holding that the whistleblower-protection provision "does not extend to or protect Asadi's extraterritorial whistleblowing activity." The district court declined to decide whether Asadi qualified as a

"whistleblower" for purposes of the whistleblower-protection provision.

The Fifth Circuit affirmed dismissal, although on different legal grounds. The court held that the plain language of the whistleblower-protection provision covers only for employees who report violations of securities law to the SEC and not those who solely report internally.

The court based its decision on the text of the whistleblower-protection provisions that define the word "whistleblower" and that specify the types of conduct that constitute protected activity under the statute. The law 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."

The provision that specifies types of protected activity, however, states that no employer can retaliate against a "whistleblower" for, among other reasons, making internal disclosures that are required or protected under any law, rule or regulation subject to the jurisdiction of the SEC.[1]

According to the Fifth Circuit, there is no ambiguity in either of these provisions. To prove its point, the court provides the following example. Say an employee reports a securities violation both to his company's chief executive officer and, secretly, to the SEC and is subsequently terminated. The employee is a whistleblower because he has reported to the SEC. As such, even though the company is unaware of his contact with the SEC, he may have a viable retaliation claim if the employer fires him for reporting to the CEO.

The court further justifies its holding by explaining that any other reading of the text would render the anti-retaliation provision of SOX moot since the two claims would be coterminous if Dodd-Frank, like Section 806 of SOX, also protected internal whistleblowers complaining of securities violations. There is some logic to this position even though the Dodd-Frank claim is better for whistleblowers in a number of ways, as it allows for greater economic damages, has no administrative-exhaustion requirement and carries a longer statute of limitations.

The Fifth Circuit's decision is likely to have significant ramifications for the internal compliance programs of publicly traded companies. After the passage of the Dodd-Frank Act, the business lobby launched a vigorous campaign to convince the SEC to require whistleblowers to report violations internally before reporting them to the SEC.

In one comment after another in the SEC's rulemaking process, large corporations and their trade associations raised the alarm that without such a requirement, an SEC program that rewarded individuals who bypassed internal channels and provided information directly to the SEC would devastate internal compliance programs and deny corporations the ability to address wrongdoing themselves before it got out of hand.

While the SEC declined to predicate eligibility for whistleblower awards on the submission of complaints internally before filing them with the SEC, the rules it issued for the program included several provisions designed to encourage whistleblowers to utilize internal compliance programs.

These include affording whistleblower status to an individual as of the date he reports the information internally, as long as he provides the same information to the SEC within 120 days; giving a whistleblower full credit for information provided by his employer to the SEC where the employee later reports the information internally, and the employer investigates and "self reports" that information to the SEC; and treating a whistleblower's participation in an internal compliance program as a positive factor in determining the amount of the award.

Additionally, the SEC issued a regulation clarifying that the whistleblower-protection provision protected whistleblowers who disclosed information only to their employers, which the Fifth Circuit struck down in Asadi as inconsistent with the statutory language of the act.

The Fifth Circuit's holding in Asadi has upset a very evenly balanced regulatory scheme that the SEC erected through careful consideration of the interests of competing stakeholders in the new whistleblower program. Even with the protections of the Sarbanes-Oxley Act, would-be whistleblowers have always faced a very real risk of retaliation when they stand up to management and report securities violations.

The expanded protections available under Dodd-Frank, which the SEC and five district courts said would apply to internal whistleblowers, would certainly have helped embolden some number of employees in raising their concerns internally. The Fifth Circuit has now said otherwise, and employees and their counsel will have to keep that in mind when deciding what to do with evidence of fraud on shareholders or other such violations. Some will decide that the risk of retaliation is too high, and the remedy too low, to justify reporting their concerns internally. Better just to avoid the internal hotline and call the SEC.

Given this blow to internal compliance programs, neither corporations nor whistleblower advocates should see the Fifth Circuit's decision as a win. Whistleblowers receive less protection, and corporations can assume that serious securities violations that they would hope to address internally will now show up first in the form of a subpoena from the SEC.

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[1] This type of internal disclosure would generally be protected under Section 806 of the Sarbanes-Oxley Act ("SOX"), 18 U.S.C. § 1514A, which prohibits retaliation against employees of publicly traded companies that report violations federal fraud laws as well as securities laws and regulations.

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