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# What's New in Financial Compliance and Regulations?

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These written materials focus on the latest developments and trends in the financial sector, including those involving whistleblowing, high-end compensation, and settlements.

## I. Bounty Programs.

Congress has provided for both the Securities and Exchange Commission and the Internal Revenue Service to pay bounties or rewards to whistleblowers who provide information leading to the investigation and recovery of penalties from corporations and taxpayers.

### A. SEC Bounty Program.

- Established pursuant to Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which added a new Section 21F to the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78u-6.
- Following the financial crisis and the Enron scandal, Congress recognized the need to incentive individuals with inside knowledge, who "face the difficult choice between telling the truth and the risk of committing 'career suicide'" to assist in identifying securities violations. S. Rep. No. 111-176, at 110 (2010).
- The SEC rewards whistleblowers who voluntarily provide "original information" about securities law violations that results in a sanction of more than $100,000. Although the SEC determines the precise amount of each "bounty," there exists a ceiling of thirty percent and a floor of ten percent of the sanction actually collected.
- Section 21F also protects whistleblowers from retaliation under 15 U.S.C. § 78u-6(h)(1)(A)(iii). There exists a split among the U.S. Courts of Appeals over whether people who report only internally and not to the SEC fall within the definition of "whistleblower" for anti-retaliation

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purposes.

  - *Somers v. Digital Realty Trust, Inc.*, 850 F.3d 1045 (9th Cir. 2017), *cert. granted*, No. 16-1276 (U.S. June 26, 2017) (holding that the Dodd-Frank Act's anti-retaliation protections extend to whistleblowers who report employers' SEC violations internally, regardless of whether they report the violations to the SEC).
  - *Berman v. Neo@Ogilvy LLC*, 801 F.3d 145 (2d Cir. 2015) (construing the provision broadly, to afford protection to internal whistleblowers).
  - *Asadi v. G.E. Energy (USA), LLC*, 720 F.3d 620 (5th Cir. 2013) (ruling that protection extends only to individuals who report employer violations outside their organizations, directly to the SEC).
  - The SEC, the agency charged with enforcing the provision, issued guidance at 17 C.F.R. § 240.21F-2, clarifying its position that a whistleblower need not report information to the SEC to qualify for protection under the Dodd-Frank Act.
  - The Supreme Court granted certiorari in *Somers v. Digital Realty* on June 26, 2107, and will hear argument in late 2017 or early 2018.
- SEC Rule 21F-6, 17 C.F.R. § 240.21F-6, sets forth the criteria used in calculating bounty awards.
- The SEC allows anonymous reporting to the commission.
- SEC enforcement actions from whistleblower tips have resulted in more than $953 million in financial remedies.
- The top ten whistleblower awards range from $4 million to $30 million.

B. IRS Bounty Program.

- In December 2006, the Tax Relief and Health Care Act of 2006 was enacted. Pub. L. 109-432, 120 Stat. 2922 (2016). It amended the Internal Revenue Code to: increase potential whistleblower bounties to thirty percent, include interest, penalties, back taxes, and other additions in the amount on which the IRS based bounties, and created the IRS Whistleblower Office to administer the award program under 26 U.S.C. § 7623.
- Amended Section 7623 of the Internal Revenue Code authorizes the Secretary of the Treasury to pay sums deemed "necessary" to detect underpayments of tax and IRS violations. The proceeds are paid from amounts that would not have been collected in the absence of the tips.

- Section 7623(b) Awards. The disputed amount (including the taxes, penalties, interest, and other amounts in dispute) must exceed $2 million, or if the tax defrauder is an individual, his or her gross income must exceed $200,000 during at least one tax year in which the illegal conduct occurred.

  - Awards are set statutorily at between fifteen and thirty percent, depending on the extent of the whistleblower's specific contribution.
  - There exists no limit on the dollar amount of the award.
  - Awards may be reduced to ten percent where the IRS proceeds "based principally on disclosures of specific allegations" resulting from a judicial or administrative hearing, from a governmental report, hearing, audit, or investigation, or from the news media, rather than from information provided by the whistleblower.
  - The bounty is based on the penalties, interest, additions to tax, and additional amounts, or the settlement amount. It includes related actions.
  - The IRS is authorized to request assistance from whistleblowers and their counsel.
  - The IRS must analyze each complaint.
  - Awards are subject to appeal to the U.S. Tax Court.

- Section 7623(a) Awards. This provision applies when the thresholds in Section 7623(b) are not satisfied.
  - Discretionary – authorizes but does not require IRS to compensate whistleblowers for tips leading to recoveries.
  - No minimum statutory award.
  - Governed by regulations at 26 CFR § 301.7623-1.
  - No appeal provisions.

- Since 2007, whistleblower tips have resulted in $3.4 billion in revenue collections, and, in turn, the IRS has approved more than $465 million in monetary awards to whistleblowers.
- During fiscal year 2016, the IRS Whistleblower Office issued 418 awards to whistleblowers totaling more than $61 million.
- In 2012, the IRS awarded Bradley Birkenfeld $104 million for information he provided about Swiss bank, UBS's illegal actions in helping wealthy Americans hide their assets and evade taxes.

## II. Protection of Whistleblower Identity.

In *Halliburton, Inc. v. Admin. Review Bd.*, an employee of Halliburton submitted an internal report about the company's fraudulent accounting practices and subsequently submitted a complaint to the SEC. 771 F.3d 254 (5th Cir. 2014) (*per curiam*). The SEC opened an investigation, and Halliburton determined, based on his internal reports, that the complainant was the source of the report to the SEC. Halliburton later disclosed the complainant's identity within the company, and as a result, his colleagues refused to work or associate with him. The ARB determined that Halliburton's disclosure of the complainant's identity constituted adverse action, and that the complainant's protected activity was a contributing factor to the adverse action. The Fifth Circuit affirmed, holding that disclosure of the employee's identity was "harmful enough that it well might have dissuaded a reasonable worker from engaging in statutorily protected

whistleblowing," and that the complainant need not prove a wrongful motive to establish causation. *Id.* at 260, 263.

## III. Whistleblower Protection for Attorneys.

Section 806 of the Sarbanes-Oxley Act ("SOX") provides protection to "any officer, employee, contractor, subcontractor, or agent" of a public company who discloses information or assists with an investigation regarding what the individual reasonably believes to constitute a securities violation, mail, wire, or bank fraud, or a federal violation concerning fraud against shareholders. 18 U.S.C. § 1514A(a).

- In *Lawson*, the U.S. Supreme Court clarified that protection under Section 1514A extends to employees of contractors and subcontractors of public companies, which would include outside lawyers. *Lawson v. FMR LLC*, 134 S. Ct. 1158 (2014) (holding that plaintiffs, employees of private companies which contracted to advise or manage mutual funds, were protected under Section 1514A).

- Section 307 of SOX, 15 U.S.C. § 7245, required the SEC to promulgate rules enumerating the standards of conduct applicable to attorneys who practice before it and "in any way" represent issuers, including rules: (1) "requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof);" and (2) if the chief legal counsel, CEO, or equivalent does not respond appropriately, requiring the attorney to report the evidence to the audit committee, the board of directors, or "another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer[.]"
    - The SEC's regulations are set forth at 17 C.F.R. §§ 205.1-7.
    - 17 C.F.R. § 205.3(b)(10) provides, "An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section."

- In *Van Asdale*, the Ninth Circuit held that in-house counsel could state a claim for retaliatory discharge under Section 806 of SOX. *Van Asdale v. Int'l Game Tech.*, 577 F.3d 989 (9th Cir. 2009). The court rejected the employer's argument that the state rules of professional conduct *per se* precluded whistleblower-retaliation lawsuits by in-house counsel and that counsel could not rely upon attorney-client communications to prove their cases.

- In *Jordan v. Sprint Nextel Corp.*, the Department of Labor similarly determined that SOX's anti-retaliation protections extend to in-house counsel. ARB Case No. 06-105, ALJ Case No. 2006-SOX-041 (DOL Admin. Rev. Bd. Sept. 30, 2009). In *Jordan*, in-house counsel for Sprint, a publicly traded company, protested *inter alia* the company's filing of inaccurate information with the SEC, its disregard for SEC rules about disclosure of executive compensation, and a senior executive's violation of company securities law compliance

policies. After the attorney reported these issues, Sprint denied him a raise and promotion and threatened to terminate his employment. Jordan filed a complaint with OSHA, and Sprint moved to dismiss the complaint on the grounds that the attorney could not establish his case without disclosing facts protected by the attorney-client privilege.

- The ALJ denied Sprint's motion but certified the case for interlocutory appeal, and the ARB affirmed. The ARB emphasized that SOX's whistleblower protection in Section 806, when read in conjunction with the SEC rules requiring attorneys to report material violations internally, and allowing them to disclose their reports in connection with certain types of proceedings and litigation, made clear that attorneys have a remedy for retaliation. As such, the ARB held that in-house counsel's otherwise-privileged communication "is nevertheless admissible in a SOX Section 806 proceeding as an exception to the attorney-client privilege in order for the attorney to establish whether he or she engaged in SOX-protected activity."

- In *Wadler v. Bio-Rad Laboratories, Inc.*, the U.S. District Court for the Northern District of California held that in-house counsel may admit otherwise-privileged attorney-client material to prove their retaliation claims under SOX and Dodd-Frank, because the federal anti-retaliation laws and the SEC's rules preempt state rules of professional conduct. *Wadler v. Bio-Rad Laboratories, Inc.*, 212 F. Supp. 3d 829 (N.D. Cal. 2016), *appeal docketed*, No. 17-16193 (9th Cir. June 8, 2017). Following a $7.29 million jury verdict for Bio-Rad's former general counsel, the company appealed, and the appeal remains pending in the Ninth Circuit.

- In *Danon v. Vanguard Group Inc.*, an in-house lawyer informed his client that he believed it was illegally reducing its reported income and tax liabilities by undercharging its affiliated mutual funds. No. 16-2881, 686 F. App'x 101, 2017 WL 1367027 (3d Cir. Apr. 12, 2017). He informed senior employees at the company who disagreed, but he persisted. After the company terminated his employment, he filed a retaliation claim under New York state law, which was ultimately dismissed. The attorney then filed a federal lawsuit in Pennsylvania, which alleged, *inter alia*, retaliation under the Dodd-Frank Act. The district court found that his claim was barred by issue preclusion and dismissed the lawsuit.[2] On appeal, the U.S. Court of Appeals for the Third Circuit held that the New York court's ruling did not preclude the attorney's Dodd-Frank claim, as the former was decided under New York law, and the latter must be decided under federal law.

- However, the law regarding former counsel's ability to serve as a relator in *qui tam* actions under the False Claims Act is less favorable to employees. *See United States ex rel. Holmes v. Northrop Grumman Corp.*, 642 F. App'x 373 (5th Cir. 2016) (*per curiam*), *cert. denied*, 137 S. Ct. 310 (2016) (affirming the district court's dismissal of former general counsel's *qui tam* suit because he violated "no less than four ethical duties" in pursuing the action, including, his duty of loyalty to the company by taking a position in direct conflict with the client's position, his intentional violation of the court's protective orders, and his duty of candor to the tribunal by lying to the court about the purposes for which he sought certain

[2] The district court also dismissed his SOX claim because he failed to exhaust his administrative remedies and his claim under the Pennsylvania Whistleblower Law because it was time-barred. The Third Circuit affirmed the district court's ruling in these respects.

documents in other proceedings); *United States v. Quest Diagnostics Inc.*, 734 F.3d 154 (2d Cir. 2013) (dismissing former general counsel's *qui tam* suit against former employer where relator's use of attorney-client material violated a state rule of professional conduct, because the False Claims Act did not evidence a clear legislative intent to preempt state statutes and rules regulating attorneys' ethical conduct); *United States ex rel. John Doe v. X Corp.*, 862 F. Supp. 1502 (E.D. Va. 1994) (holding that in-house counsel are not *per se* barred from serving as relators in *qui tam* actions but that in this case, counsel could not proceed as the relator because he learned of the facts supporting his claim only through his privileged and confidential communications with his client, the disclosure of which would violate an injunction the court previously issued, which prohibited the attorney from disclosing client confidences pursuant to the state ethical rules).

## IV. High-End Compensation.

### A. Say on Pay.

- Section 951 of the Dodd-Frank Act requires public companies to provide their shareholders a "say on pay" vote, at least once every three years, to approve the compensation of the "named executive officers" listed in the Summary Compensation Table contained in the company's proxy statements.
- The vote is advisory only and non-binding.
- Section 951 also requires each company to submit to its shareholders, at least once every six years, how frequently the "say on pay" vote should occur.
- The first votes took place in 2011.
- "Say on pay" votes are generally in the ninety percent and up approval range.

### B. The SEC's Pay-Disclosure Rule.

- In August 2015, the SEC adopted a final rule under the Dodd-Frank Act, which required public companies to disclose the ratio of the compensation its chief executive officer receives, in comparison to the median compensation of its employees. The rule was intended to help inform shareholders when voting on "say on pay."
- Under the current rule, companies must provide disclosure of their pay ratios for their first fiscal year beginning on or after January 1, 2017.
- However, companies may select their methodology for identifying median employees and their compensation, including through statistical sampling of their employee population or other reasonable methods.
- The rule permits companies to make the median employee determination only once every three years and to choose the date on which such a determination is made, so long as it is within the last three months of the fiscal year.
- In performing calculations, companies may exclude non-U.S. employees

in countries whose privacy laws and regulations preclude the companies from providing the information.
- On February 6, 2017, newly-appointed SEC Chairman Michael S. Piwowar issued a public statement which called the SEC rule into question. Further, the House Financial Services Committee is considering the Financial Choice Act of 2017, which seeks to repeal the pay-ratio disclosure provisions.

C. Characterization of Executive Income as Dividends or Salary.

- **Company Advantage:** Generally, companies seek to characterize payments to employees as salary/wages/bonuses, rather than dividends, to receive preferential tax treatment. At a corporate tax rate of about thirty-five percent, for each dollar a company pays in salary, it saves about 35 cents, as salary is deductible. However, dividends are *not* deductible by the corporation, and thus the corporation derives no benefit from making a dividend payment.
    - Internal Revenue Code Section 162(a)(1) permits a deduction for a "reasonable allowance for salaries or other compensation for personal services actually rendered."
    - To be deductible, the compensation must be: (1) ordinary and necessary; (2) reasonable in amount; (3) paid for services actually provided; and (4) actually paid or incurred in the year for which the company claims the deduction.
- **Employee Advantage:** Most dividends paid on corporate stocks are "qualified dividends" (versus nonqualified dividends). Qualified dividends are taxed at long-term capital gains rates, which are lower than ordinary income tax rates. Thus, most executives would prefer to receive payment in the form of corporate stock dividends, rather than salary, wages, or bonuses.
- To receive a larger corporate tax savings, a company must trade off a higher individual tax rate.
- **IRS Scrutiny:** Companies' characterizations are subject to IRS scrutiny.
    - The IRS may analyze whether a portion of funds deducted as salary are actually dividends. Regulations provide that "the test of deductibility in the case of compensation payments is whether they are *reasonable* and are in fact payments purely for services. . . . An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock." 26 C.F.R. § 1.162-7

(emphasis added).

  - Treas. Reg. §1.162-8 provides that if excessive payments "are found to be a distribution of earnings and profits, the excessive payments will be treated as a dividend."
  - The IRS is more likely to scrutinize closely held companies' payments than public companies' payments, as employees in the former typically have more control over the company and do not usually operate at arms' length.

D. Disclosure in Proxy Statements.

- In its annual proxy statement, a company must disclose information about the amount and type of compensation paid to its CEO, CFO, and the three other most highly compensated executive officers, as well as the criteria used in reaching executive compensation decisions and the relationship between the company's executive compensation practices and corporate performance.

## V. Valuation of Stock Options.

A. Overview.

- Over the past two decades, courts have grappled with the issue of how to value former employees' unvested or unexercised stock options. *See Scully v. US Wats, Inc.*, 238 F.3d 497, 507 (3d Cir. 2001) ("[J]udicial adjudication of stock option controversies is becoming more common due to the widespread use of options as incentives and bonuses"). Fluctuating market prices and the benefit of hindsight create uncertainty as to the value of the option on the date it would have vested or would have been exercised, absent the employer's unlawful conduct.
- The value of a stock option is a function of the difference between the strike price (the price for which the employee purchases the stock) and the actual market value of the stock when the employee exercises his or her option. The face of the stock option certificate lists the strike price, but the market value varies day to day and depends upon the specific date on which the option is exercised.
- In assessing the market value of stock, courts seek to strike a balance between making plaintiffs whole for unlawful termination and eliminating speculation from the damages equation. To this end, the courts have developed a variety of approaches to valuing stock options, depending upon the particular facts and circumstances of each case.

B. Primary Valuation Theories.

1. *Breach of Contract Theory.*
   - The breach of contract theory seeks to "put the plaintiff in the same

position he would have held had the breach never occurred." *Id.* at 510. Pursuant to this theory, the court calculates damages based on "the difference between a stock option's exercise price and the market price of the same stock at the time of breach," e.g., the non-delivery of the stock. *Id.* Because the breach of contract theory determines lost profits as of the date of the breach, it does not allow a plaintiff to recover any additional profit which would have accrued beyond the date of the breach. *Id.* at 510.

2. *Conversion Theory.*
   - The conversion theory seeks to compensate a plaintiff "for actual loss," including lost profits that accrued a reasonable time *after* the date of the breach. *Id.* at 509. The conversion theory values damages based on the difference between the exercise price and "(1) the value of the stock at the time of conversion, or (2) the highest intermediate stock price between the notice of conversion and a reasonable time thereafter during which the stock could have been replaced, or whichever is greater." *Id.*

3. *Comparison.*
   - As the *Scully* Court explained, the breach of contract theory eliminates uncertainty in market value; it sets the valuation date as the date of the breach, and enables the factfinder to determine, based on market records, the value of the stock on that specific date. While the breach of contract theory provides certainty, it nonetheless "distort[s] the damage calculation"; it ignores the likelihood that the plaintiff would have earned an increased profit after the defendant's wrongful conduct and arguably rewards the defendant by depriving the plaintiff of the lost profit. *Id.* at 511.
   - While the conversion theory allows a plaintiff to recover a limited amount of future profit, it suffers from other shortfalls. It provides the plaintiff the hindsight advantage of knowing the date on which it would have been most advantage to sell his or her stock and enables the plaintiff to tailor the evidence at trial to a theory that maximizes damages. *Id.* Further, it injects uncertainty into the damages equation by extending the plaintiff's exercise period for an unspecified "reasonable time." *Id.*
   - Neither the breach of contract theory nor the conversion theory can be applied universally to value stock options. Rather, the court must "weigh[ ] and balance[ ] the strengths and weaknesses of competing damage calculation methods to achieve the requisite end of putting [plaintiff] in the position most closely reflecting the one he would have held absent [employer's] breach." *Id.* at 512.

C. Additional Valuation Tools.

1. *Marketability Discount.*
   - Pursuant to the marketability discount, courts apply a percentage-based discount to the value of stock, to account for restrictions on the stock at the time of valuation.
   - For example, if a court determined that stock was worth $300,000 at the time of an unlawful termination pursuant to the breach of contract theory, but the stock did not vest until three months after the termination, the court could apply a discount to reflect the restricted marketability.
   - The amount of the discount depends on factors such as the employee's expected tenure with the employer, length of the restriction, constraints on the employee's ability to hedge or borrow against the restricted shares, and the volatility of the stock price. *See Parry v. Parry*, 933 So. 2d 9, 15 (Fla. Dist. Ct. App. 2006) (holding that the trial court did not abuse its discretion by applying a marketability discount when "numerous regulations and restrictions" limited the employee's ability to sell it); *Davidowitz v. Patridge*, No. 08 Civ. 6962 NRB, 2010 WL 5186803 (S.D.N.Y. Dec. 7, 2010) (discounting plaintiff's damages for former employer's failure to deliver stock pursuant to his option agreement to $.01 per share, even though the market value was $1.05 per share, because the stocks were restricted and plaintiff would most likely sell them through a block sale to a private investor).

2. *Hybrid Methods.*
   - In *Commonwealth Assocs. v. Palomar Med. Techs., Inc.*, the court expressly applied the breach of contract theory in calculating the damages from the defendant's failure to deliver stock warrants, but nonetheless, compensated the plaintiff for lost profits that would have accrued *after* the date of the breach. 982 F. Supp. 205, 211 (S.D.N.Y. 1997).
   - Similarly, in *Moser v. Encore Capital Grp., Inc.*, the district court explained that "[i]n breach of contract cases, valuing stock options on the date of the breach is typically preferable to utilizing a valuation date that is based solely on a plaintiff's speculation as to when he 'would have' exercised his options." 964 F. Supp. 2d 1224, 1226–27 (S.D. Cal. 2012). However, the court continued that a "valuation date subsequent to the breach may nonetheless be appropriate in certain limited circumstances where 'adequate evidence confirm[s] a plaintiff's professed intent concerning the exercise' of his stock options." *Id.* In support of this proposition, the court relied upon the opinion in *Greene v. Safeway Stores, Inc.*, a case addressing the plaintiff's ADEA claim.

- **Black-Scholes.** The Black-Scholes method is a widely accepted formula for calculating the value of stock options in the employment, marital-property division, and taxation contexts, developed by Fischer Black and Myron Scholes. *See* F. Black & M. Scholes, "The Pricing of Options and Corporate Liabilities," 81 J. POL. ECON. 637 (1973). Through a mathematical formula, the Black-Scholes method "takes into account the option price, the term of the option, the market value of the underlying security, a risk-free rate of return, and the underlying volatility of the stock option, in order to come up with a present value for the options at issue." *Davidson v. Davidson*, 578 N.W.2d 848, 858 (Neb. 1998); *see also Mathias v. Jacobs*, 238 F. Supp. 2d 556, 574 n. 12 (S.D.N.Y. 2002).

  This formula "calculates the theoretical value of the stock (call) option as a function of the strike price, the elapsed time period, the interest rate multiplied by the strike price, and the volatility component. The actual formula requires two differential equations . . . , but independent judgment is necessary to determine the volatility component, since past volatility may not accurately predict future volatility. In other words, the output of the Black-Scholes formula depends upon the input, and dueling expert economist witnesses may arrive at highly divergent estimates for the volatility component." L. Bernabei & A.R. Kabat, "Stock Options and Employment Discrimination Law," 11-12 (2000), *available at* www.bernabeipllc.com/pdfs/stockoptions.pdf.

D. Application.

- Experts are likely to disagree about the proper model to apply when valuing stock options. Trial courts and/or jurors are given great latitude in determining which expert to credit, as such decisions are within the purview of the factfinder. Appellate courts will reverse the factfinder's decisions only when it committed manifest error or its decision lacks support in the record. *See, e.g. Hansel v. Holyfield*, 779 So. 2d 939 (La. Ct. App. 2001) (upholding the trial court's decision to accept the plaintiff's present-value method and discount-rate method over the defendant's use of the Black Sholes model because its decision "was not manifestly erroneous or clearly wrong"); *In re Marriage of Robinson and Thiel,* 35 P.3d 89, 91 (Ariz. Ct. App. 2001) (declining to adopt a universal valuation method and leaving the decision to the trial court's discretion, based on factors such as the nature of the stock options, market conditions, tax consequences, and the ease of applying a particular method); *Fountain v. Fountain*, 559 S.E.2d 25, 32 (N.C. App. 2002) (declining to adopt a single approach to the valuation of stock options and explaining, "the trial court's valuation method will be accepted by this Court if it is a sound valuation method, based on competent evidence").

1. *Breach of Contract Theory.*
   - In *Scully v. US Wats, Inc.*, the defendant-employer wrongfully terminated the plaintiff-employee in violation of his two-year employment contract. 238 F.3d 497, 507 (3d Cir. 2001). The plaintiff's stock-option agreement stated that stock options expired thirty days after termination. The plaintiff attempted to exercise his options in a timely manner, but the employer prohibited him from doing so, in violation of his stock-option agreement.

     The district court applied the breach of contract theory and valued *all* his stock options on the date of the breach of his stock-option agreement—not the employment contract. The court declined to apply a marketability discount, even though it recognized that some of his stock options had not vested as of the date of the breach and therefore, could not have been sold on that date. The Third Circuit Court of Appeals affirmed and reasoned, "absent his wrongful termination, [plaintiff] would have fully exercised his option after all shares had vested." *Id.* at 508.

     Further, the appellate court affirmed the trial court's refusal to value the stock as of the date the restrictions would lift as too speculative and emphasized that as the restriction period grows, so, too, does the uncertainty involved in assessing damages. The Court of Appeals noted that restrictions which extend beyond trial "would be particularly problematic" because "the vagaries of the stock market render valuation of the security interest more speculative." *Id.* at 513.

   - In *Boyce v. Soundview Tech. Group, Inc.*, the Second Circuit held that the value of stock options an employer prohibited a former employee from exercising in breach of his contract must be determined on the date of the breach, regardless of whether the breach occurred before or after an IPO that substantially affected the option's value. 464 F.3d 376 (2d Cir. 2006).

   - Similarly, in addressing a private contract for the sale of securities in *Kovens v. Paul*, the district court explained, "expectation damages are calculated as the difference between the agreed price of the shares and the fair market value at the time of the breach." No. 04 Civ. 2238 (TPG), 2009 WL 562280, at *4 (S.D.N.Y. Mar. 4, 2009) (internal quotation marks omitted).

   - **Absence of Not-for-Cause Termination Provision.** In *Knox v. Microsoft Corp.*, the plaintiff sued his former employer for breach of his employment contract and sought as damages the value of his unvested stock options. 962 P.2d 839, 841 (Wash. App. 1998). The lower court entered partial summary judgment in favor of the employer on the issue of damages and concluded that the employee's stock option agreement,

which stated that not-yet-vested stock options expired on the date of termination, precluded him from recovering his "lost" options.

On appeal, the Court of Appeals of Washington reversed. It explained that the stock option agreement permitted the employer to cancel the stock options upon the employee's termination but did not preclude the employee from recovering damages from the cancellation, because "the general measure of damages for breach of contract--which is applicable to employment contract cases--is that the injured party is entitled to: (1) recovery of all damages that accrue naturally from the breach, and (2) be put into as good a position pecuniarily as he would have been had the contract been performed." *Id.* at 841. Because the "lost" options flowed naturally from the breach, and because their recovery was necessary to put the plaintiff in the same pecuniary position in which he would have been but for the breach, the court ruled that he could recover their value.

- **Presence of Not-for-Cause Termination Provision.** In *Oracle Corp. v. Falotti*, the plaintiff claimed that the defendant breached his employment contract and sought as damages the value of stock which did not vest because of his termination. 187 F. Supp. 2d 1184, 1186 (N.D. Cal. 2001), *aff'd*, 319 F.3d 1106 (9th Cir. 2003). However, prior to the start of his employment, the plaintiff negotiated a severance agreement that became effective upon his not-for-cause termination, under which half of the plaintiff's unvested stock options vested on an accelerated schedule. The court ruled that nothing in the employment contract, the severance agreement, or the stock-option agreement entitled the plaintiff to the vesting of additional stocks, and the Ninth Circuit Court of Appeals affirmed.

2. *Conversion Theory.*
   - In *Greene v. Safeway Stores, Inc.*, a plaintiff sued his former employer for terminating his employment in violation of the ADEA. 210 F.3d 1237, 1244 (10th Cir. 2000). The employer forced the employee to exercise his stock options at the time of his termination. The employee claimed that but for the termination, he would not have exercised his options until a future date and introduced evidence consistent with this theory. The court held that the plaintiff could recover "[t]he difference in the value of the options at the time [the plaintiff] was forced to exercise them [the stock options], and their value when he otherwise would have exercised them" because the value was "contingent compensation" he would have received absent the illegal conduct.

   - *But see Lucente v. IBM*, 310 F.3d 243, 261 (2d Cir. 2002) (holding that the district court erred when it applied the conversation theory to evaluate the plaintiff's damages, which arose under a breach of contract claim).

## VI. Settlement Agreements.

When a corporation and a former employee or executive enter into a settlement or severance agreement in resolving the separation from the company, what must the company disclose in its public filings? Can the settlement or severance agreement waive future claims, including those under the False Claims Act or the Dodd-Frank Act? Can an employer insist on total confidentiality?

### A. Disclosure of Resolution of Litigation (Form 10-K).

- **Trigger:** If a company is being sued, SEC Regulation S-K Item 103 requires a brief description of any "material pending legal proceedings, other than ordinary routine litigation incidental to the business," to which the company or a subsidiary is a party, or to which its property is subject. The company must also disclose proceedings it knows governmental authorities are contemplating. 17 CFR § 229.103.
    - "Material" means any information "to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered." 17 CFR § 240.12b-2.
    - **Required Disclosure:** the name of the court or agency in which the proceedings are pending, the date the proceedings were instituted, the principal parties thereto, and a description of the alleged factual basis and the relief sought.

    - **Instructions to Item 103**:
        - Actions or claims need only be disclosed if they depart from the "normal" kinds of actions the business ordinarily faces in its operations.
        - Disclosures need not be made where the amount of damages sought (excluding interest and costs) does not exceed ten percent of the assets of the company and its subsidiaries. Where actions involves common claims or factual issues, the potential damages from the action should be combined with those of the other "pending or known to be contemplated" actions.
        - Where a "material" proceeding involves any of the following as a party, it must be disclosed: any director, officer, or affiliate; any owner or beneficiary of more than five percent of any class of voting securities of the company; any associate of any such director, officer, or affiliate of the company; where a security holder or subsidiary is a party adverse to the company; or where the security holder or subsidiary has a material interest adverse to the company.
        - Proceedings arising under any federal, state, or local law

regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment shall not constitute "ordinary routine litigation incidental to the business" and shall be described if: (1) the proceeding is material to the business or financial condition of the company; (2) the proceeding involves primarily a claim for damages or potential monetary sanctions, capital expenditures, deferred charges, or charges to income, and the amount involved exceeds ten percent of the current assets of the registrant and its subsidiaries; or (3) a governmental authority is party to the proceeding, and it involves potential monetary sanctions, *unless the company reasonably believes that the resulting sanctions will be less than $100,000.*

- The SEC also requires disclosure of any proceedings by government agencies or any action in which an officer or director of the company, or any shareholder with more than five percent ownership, is one of the parties suing the company. Failure to disclose litigation can result in an SEC investigation. If SEC investigators find reasonable cause for an enforcement action, the agency will notify company officers involved in the investigation by filing a "Wells notice." The enforcement action may result in an injunction that compels the company to disclose the lawsuit. The SEC may also levy a civil penalty as a condition of settling the matter.
- When a legal proceeding has terminated during the period covered by the report, the company must provide the date of termination and a description of the disposition with respect to itself and its subsidiaries.

B. Disclosure of Resolved Litigation (Form 10-K Quarterly Report).

- Disclosure need only be reported in the 10-Q for the quarter in which it first became a reportable event, and in subsequent quarters where there have been material developments.

C. Disclosure of Executive's Departure (Form 8-K).

- Pursuant to the SEC's 2004 Final Rule on Form 8-K under the Securities Exchange Act of 1934, Item 5.02(b) regarding "Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers," requires disclosure when the company's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions retires, resigns, or is terminated from that position. The item also requires disclosure when a director retires, resigns, is removed, or declines to stand for re-election, and the company is not required to provide disclosure under Item 5.02(a).
    - Initially, the SEC considered requiring companies to disclose the

reason for the departures, but following a comment period, rejected the requirement due to fear that the filings could result in lawsuits for defamation, invasion of privacy, and other reputation-based actions.

D. Disclosure on Form U-5.

- The Financial Industry Regulatory Authority's Form U-5, the Uniform Termination Notice for Securities Industry Registration for self-regulatory organizations, "asks the reason for the termination; it is typically requested by member firms whenever a broker applies for a new job. Although the forms were designed to provide both member firms and the public with information about brokers' conduct, they also can be used to smear and defame former employees." *Rosenberg v. Metlife, Inc.*, 453 F.3d 122, 123 (2d Cir. 2006).
- Under FINRA Rule 4530, FINRA members must submit the Form U-5 to FINRA's Central Registration Depository System (CRD), an online database of information about registered employees of FINRA's member firms, within thirty days of the employee's dismissal and must provide the employee a copy.
- The employer must explain the reasons for termination on the Form U–5. *Rosenberg v. MetLife, Inc.*, 866 N.E.2d 439, 440–41 (N.Y. 2007). The form "contains a number of disclosure questions that address whether the employee had been subject to criminal charges, customer complaints or an internal review for violating investment-related rules. If any of these inquiries is answered in the affirmative, a corresponding disclosure reporting page directs the employer to explain the nature of these allegations." *Id.*
- Specifically, the form requires the employer to characterize the reason for the termination as one of the following: "Discharged"; "Other"; "Permitted to Resign"; "Deceased"; or "Voluntary." FINRA, Revised Form U-5 (May 2009), at 2. If the termination was not voluntary and not due to death, the employer must provide an explanation. *Id.*
- Further, the employer must answer a list of disclosure questions regarding whether the employee:
    - is or was "the subject of an investigation or proceeding by a domestic or foreign governmental body or self-regulatory organization with jurisdiction over investment-related businesses";
    - is or was "under internal review for fraud or wrongful taking of property, or violating investment-related statutes, regulations, rules or industry standards of conduct";
    - was charged, convicted of, or pled guilty or nolo contendere to any felony or misdemeanor involving "investments or an investment-related business, or any fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these

offenses";
    - was "involved in any disciplinary action by a domestic or foreign governmental body or self-regulatory organization (other than those designated as a 'minor rule violation' under a plan approved by the U.S. Securities and Exchange Commission) with jurisdiction over the investment-related businesses";
    - was named as a respondent in an "investment-related, consumer-initiated arbitration or civil litigation" which alleged that the employee was involved in sales practice violations, and resulted in an arbitration award or civil judgment (in any amount) against the employee, was settled before May 18, 2009 for $10,000 or more, was settled on or after May 18, 2009 for $15,000 or more, or is still pending;
    - was named as a respondent in an "investment-related, consumer-initiated written complaint" that did not result in arbitration proceedings or civil litigation, but which would be reportable under the Form U-4 (regarding the registration of broker-dealer agents and investment-adviser representatives), if the employee were still employed; and
    - voluntarily resigned, or was permitted to resign, following allegations that the employee violated investment-related statutes, regulations, rules, or industry standards of conduct, failed to supervise others in connection with investment-related statutes, regulations, rules, or industry standards of conduct, or committed fraud or wrongful taking of property.

- Where an employer answers any of the above disclosure questions affirmatively, it must provide details of the underlying events. *Id.* at 7.
- FINRA has criticized its members for describing the basis of a former employee's termination as violation of "firm policy," because such information does not "provide sufficient detail" that enables "a reasonable person [to] understand the circumstances that triggered" the response. FINRA Reg. Notice 10-39, "Form U-5" (Sept. 2010), at 2. Where a firm cites violation of its policy as the basis for termination, it must "identify the policy, provide sufficient facts and circumstances to enable the reader to understand what conduct was involved, and review other questions on the form to determine whether an affirmative response to any other question is required." *Id.*
- Upon receipt of the Form U-5, FINRA may investigate a termination for cause to determine whether the employee violated any security rules. *Id.* at 1; *Rosenberg*, 866 N.E.2d at 444 ("The form is often the first indication . . . regarding possible misconduct by members of the securities industry, and investigations of misconduct reported on the Form U–5 frequently lead to the initiation of disciplinary action[.]").
- Further, the Form U-5 aids "prospective member employers in researching the backgrounds of potential employees," since potential employers must

review applicants' most recent Form U-5 during the hiring process. *Rosenberg*, 866 N.E.2d at 444.

- Therefore, false statements on the Form U-5 can substantially impact a broker-dealer's future employment prospects and may subject him or her to unwarranted investigation.

- **Protection**. Court decisions vary from state to state regarding the degree of protection to which statements on the Form U-5 are entitled.

  - **Qualified Immunity.** *See, e.g.*, *Glennon v. Dean Witter Reynolds, Inc.*, 83 F.3d 132 (6th Cir. 1996); *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704 (7th Cir. 1994); *Fahnestock & Co., Inc. v. Waltman*, 935 F.2d 512 (2d Cir. 1991); *Dickinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 431 F. Supp. 2d 247, 261-62 (D. Conn. 2006) ("Merrill Lynch's statements on the Form U–5 are protected by a qualified, and not an absolute, privilege."); *Eaton Vance Distributors, Inc. v. Ulrich*, 692 So. 2d 915, 916 (Fla. Dist. Ct. App. 1997) ("We reject the claim that statements made in a Form U-5 are absolutely privileged. We conclude that defamatory statements on a Form U-5 are actionable, and they are subject only to a qualified privilege."); *Andrews v. Prudential Sec.*, 160 F.3d 304 (6th Cir. 1998); *Prudential Sec. v. Dalton,* 929 F. Supp. 1411 (N.D. Okla. 1996); *Haburjak v. Prudential Bache Sec.*, 759 F. Supp. 293 (W.D.N.C. 1991).

  - **Absolute Immunity.** *Rosenberg v. Metlife, Inc.*, 866 N.E. 2d 439 (N.Y. 2007) (holding that statements in the Form U-5 are entitled to absolute immunity under New York law); *Romaneck v. Deutsche Asset Mgmt.*, No. C05-2473 TEH, 2005 WL 2171987, at *6 (N.D. Cal. Sept. 6, 2005) (holding that under California state law, courts afford statements on the Forum U-5 absolute immunity).

  - **Distinction.** Whereas statements accorded an absolute privilege entitle their maker to absolute immunity from a lawsuit premised on the defamatory nature of those statements, "[t]he shield provided by a qualified privilege may be dissolved if [the] plaintiff can demonstrate that [the] defendant spoke with malice." *Rosenberg v. Metlife, Inc.*, 453 F.3d 122, 123 (2d Cir. 2007) (internal quotation marks omitted).

  - **Expungement.** Form U-5s are filed via FINRA's CRD system, and only FINRA can expunge misstatements on the forms. Under Rule 2080 of FINRA's Code of Arbitration Procedure for Industry Disputes, FINRA will expunge such information from the CRD

system pursuant to a court order providing expungement relief or a court-affirmed arbitration award providing expungement relief.

- Where a former employee seeks court approval of an arbitration decision awarding expungement relief, the employee must name FINRA as a party and serve copies of all filings upon FINRA, unless FINRA waives the requirement. *See* FINRA Code of Arbitration Procedure for Industry Disputes 2080(b)(1).
- In *Minevich v. Wells Fargo Advisors, LLC*, Case No. 10-04973 (FINRA Arbitration Dec. 8, 2011), the arbitration panel unanimously determined that claimant's supervisor "knowingly and willfully presented false, misleading and inaccurate information" to bank officials, which was incorporated into claimant's U-5. As such, it awarded claimant compensatory damages for lost wages and loss of career, punitive damages, attorneys' fees, and expungement of Wells Fargo's termination comments in his U-5.

  Further, the panel ordered that the following language replace Wells Fargo's termination explanation: "Discharged by Wachovia Bank for conduct unrelated to the business of Wells Fargo Advisors. FINRA Arbitrators found the termination was unwarranted. It was based upon one customer verbal complaint that was resolved to the satisfaction of the customer. The Manager, who had a personal animus against Mr. Minevich, presented false and inaccurate information to the Manager's supervisor, which led to the termination. The Manager willingly and knowingly under oath presented false testimony to the Panel." *Id.*; *see also Fulco v. Banc of Am. Invest. Servs.*, Case No. 12-03686 (FINRA Arbitration May 24, 2013) (awarding expungement of information about an unfounded customer complaint MetLife received, because the information was "factually impossible or clearly erroneous" since the "uncontested facts demonstrate that Claimant's client misunderstood the surrender provisions of the financial product," subject to "confirmation from a court of competent jurisdiction, before the CRD will execute the expungement directive").

- **BrokerCheck.** FINRA releases information about certain employees of FINRA member firms through "BrokerCheck," a tool through which individuals can inquire about financial brokers', advisers', and firms' qualifications. FINRA Rule 8312(a)-(d) specifies the information FINRA will and will not release.

- ***Disputes.*** As an easier but less-effective alternative to seeking expungement, certain individuals' whose information may be distributed under FINRA's BrokerCheck program may request to dispute the accuracy of the information. Pursuant to FINRA Code of Arbitration Procedure for Industry Disputes Rule 8312(e), an individual may submit a written request detailing the misinformation on his or her report, after which FINRA will, assuming the information is available for investigation, notate on the report that the individual disputes the information. Following an investigation, FINRA may update, modify, or remove the disputed information, or maintain it as is. FINRA's final determination is not subject to appeal.

- ***Comments.*** Individuals who are not currently registered with FINRA, but whose information is subject to disclosure under BrokerCheck, may request to comment upon the disclosed information by submitting a Broker Comment Request Form. FINRA will add the comment to provide context to disclosures, so long as: (1) the individual is not currently registered with FINRA; (2) the comment concerns the BrokerCheck report of the individual who submitted the request; (3) the comment concerns information disclosed through the BrokerCheck program; (4) the comment is written in first-person; and (5) the comment omits confidential or identifying information about other individuals, offensive or potentially defamatory language, and information that raises significant identity theft, personal safety, or privacy concerns.

- When FINRA accepts a comment, it will post it within thirty days. The comment will remain so long as the individual's report is publicly available. An individual may update or delete a comment by submitting a new request form. If the individual becomes registered with FINRA after submitting the comment, the comment will no longer display, but the individual may provide the same information through a Form U-4 or a dispute.

E. Waiver of Future Actions.

1. *False Claims Act.*
    - Generally speaking, waivers of future *qui tam* damages are not invalid *per se*, but may be invalidated on a case-by-case basis, depending on whether public policy counsels in favor of

enforcement.

- Typically, where the government is unaware of potential false claims, public interest favors the use of *qui tam* suits over enforcement of the release. Conversely, when the government is aware of the claims prior to the filing of the *qui tam* suit, public policy tends to favor enforcement of the settlement provision. Whether the government was already on notice of the claims, and not whether it completed its investigation, is key.

- *United States v. Purdue Pharma L.P.*, 600 F.3d 319 (4th Cir. 2010): "When the government is unaware of potential FCA claims the public interest favoring the use of *qui tam* suits to supplement federal enforcement weighs against enforcing prefiling releases. But when the government is aware of the claims, prior to suit having been filed, public policies supporting the private settlement of suits heavily favor enforcement of a prefiling release. We therefore agree with the government that '[t]he proper focus of the inquiry is whether the allegations of fraud were sufficiently disclosed to the government, not on whether the government's investigation was complete.'" *Id.* at 332 (enforcing the waiver provision where government had prior knowledge of *qui tam* claims but had not yet completed its investigation).

- *United States ex rel. Hall v. Teledyne Wah Chang Albany*, 104 F.3d 230 (9th Cir. 1997) (enforcing a release of *qui tam* damages where, prior to filing a *qui tam* action, the plaintiff notified the government of the employer's conduct, and therefore, the government was already aware of the allegations).

- *United States ex rel. Green v. Northrop Corp.,* 59 F.3d 953, 960 (9th Cir. 1995) (declining to enforce a general release because, prior to the plaintiff's *qui tam* suit, the government had not been apprised of the allegations of wrongdoing).

- *United States ex rel. Ladas v. Exelis, Inc.*, 824 F.3d 16, 24 (2d Cir. 2016) (declining to enforce the settlement provision "as a matter of public policy because the record belie[d] the district court's conclusion that the government had sufficient knowledge of [Plaintiff]'s allegations of fraud or of any related fraud allegations."). The employer self-disclosed a "change in process" that would "have no significant effect" to the government but that disclosure was based on false statements.

- *United States ex rel. Ritchie v. Lockheed Martin Corp*., 558 F.3d 1161, 1170 (10th Cir. 2009) (enforcing the waiver where the

employer self-disclosed Plaintiff's allegations to the government before the Plaintiff filed the *qui tam* action, even though the employer "whitewashed" the accusations by telling the government they lacked merit, and even though the government had not yet completed its audit at the time Plaintiff filed).

- However, some courts have deemed releases of future *qui tam* damages invalid. *See United States ex rel. Longhi v. United States*, 575 F.3d 458, 473 (5th Cir. 2009) (holding that such releases are *per se* invalid under the FCA).

- The U.S. District Court for the District of Columbia did not rule that such releases were *per se* invalid, but its opinion did contain broad policy language, arguably applicable to most releases. *See United States ex rel. El-Amin v. George Washington Univ.*, No. CIV A 95-2000 JGP, 2007 WL 1302597 (D.D.C. May 2, 2007). In the case, the district court invalidated the release on the following public-policy grounds: (1) 31 U.S.C. § 3730(b)(1) provides that a *qui tam* complaint can be voluntarily dismissed "only if the court and the Attorney General give written consent to the dismissal and their reasons for consenting", and the effect of a release is similar to a voluntary dismissal; (2) 31 U.S.C. § 3730(b)(2) delineates the filing requirements of a *qui tam* complaint and mandates that it be filed under seal for sixty days to give the government an opportunity to evaluate the suit's merit, and a release that becomes effective during this period "would eviscerate" these purposes; and (3) enforcing a release would frustrate the financial incentives enumerated in 31 U.S.C. § 3730(d), which were designed to encourage relator participation.

2. *Dodd-Frank Act.*
   - The courts have not yet addressed the viability of a severance or settlement agreement clause that releases or waives Dodd-Frank claims.

   - Several rationales counsel against enforcing such provisions:
     - SEC Rule 21F-17 expressly prohibits any company or individual from preventing individuals from communicating with the SEC.
     - The Dodd-Frank whistleblower scheme seeks to reward individuals for providing information to the SEC, not to compensate them for retaliation they faced, thus ensuring whistleblowers do not receive a double-recovery and employers do not receive a double penalty, particularly given that SEC whistleblower awards are paid from the general fund and not by the employer.

- The SEC has penalized employers whose settlement agreements prevented former employees from communicating with the SEC or from collecting SEC bounty awards:
  - *SEC v. BlueLinx Holdings Inc.*, Admin. Proc. File No. 3-17371 (Aug. 10, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-78528.pdf. The SEC issued a consent order and imposed sanctions on BlueLinx because of a provision in its standard severance agreement that required employees to waive their rights to receive monetary awards, if the employee reported information to the SEC or another federal agency that resulted in a monetary sanction, because the provision undercut a key tenant of the SEC's whistleblower program. Further, the severance agreement required employees to notify the employer's legal department before reporting information to the SEC. The SEC found that the provisions hampered employees' ability to report violations to the SEC and required BlueLinx to amend its agreement to state that employees could collect monetary awards in connection with providing information to the SEC or other government agencies.
  - *SEC v. Health Net, Inc.*, Admin. Proc. File No. 3-17396 (Aug. 16, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-78590.pdf. Similar to *BlueLinx*, the SEC imposed sanctions on Health Net, Inc. due to a provision in its severance agreement that required employees to waive their rights to collect monetary awards from the SEC pursuant to its whistleblower program. After the SEC adopted Rule 21F-17, Health Net removed language from its agreement that prohibited employees from disclosing information to the SEC and replaced it with language that barred employees from collecting monetary awards for their disclosures to government agencies. The SEC explained that Health Net's amendment attempted to strip away the financial incentives that underpin the SEC's whistleblower program.

Arguably, the rationale the SEC applied when invalidating settlement provisions that inhibited its whistleblower program also applies to settlement provisions restricting employees' rights to collect damages under the FCA.

F. Confidentiality Provisions.

- To fulfill the congressional intent of Section 21F of the Dodd-Frank Act, the SEC adopted Rule 21F-17, which states in relevant part, "No person may take

any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications."

- Rule 21F-17 precludes employers from including certain confidentiality provisions in agreements with their employees. For example, employers cannot: require employees to represent that they have not assisted in any investigations of the employers; broadly prohibit any and all disclosures of confidential information, unless a carve out is made for voluntary communications with the SEC concerning potential SEC violations; require employees to notify or obtain consent from the employer before disclosing confidential information, unless a carve out is included for voluntary communications with the SEC concerning potential SEC violations; or permit disclosure of confidential information only as *required* by the law, unless a carve out is included for voluntary communications with the SEC concerning potential SEC violations.

- The SEC has sanctioned companies for their broad confidentiality provisions, on the basis that they impede communication with the SEC.

    - The SEC sanctioned Merrill Lynch, Pierce, Fenner & Smith because its standard severance agreement prohibited employees from disclosing *any* confidential information or trade secrets to anyone outside the company or its affiliates, except pursuant to formal legal process or with the company's prior written approval. *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorp.*, Admin. Proceeding File No. 3-17312 (June 23, 2016), available at https://www.sec.gov/litigation/admin/2016/34-78141.pdf. Later, Merrill Lynch amended its confidentiality provision to allow direct communication with the SEC but provided that employees could provide the SEC only with information related to a severance agreement or the agreement's "underlying facts and circumstances."

      As part of the settlement, Merrill Lynch agreed to include language in its severance agreements stating that with the exception of information protected from disclosure by applicable law or privilege, the agreement does not prohibit or limit an employee from initiating communications directly with, responding to, or providing testimony before the SEC in connection with any investigation, report of, or proceeding about suspected legal violations. The new language also clarified that the employee need not notify, or seek permission from, the employer before engaging in such activity.

- The SEC also sanctioned Anheuser-Busch for language contained in its severance agreement with a former employee, which violated Rule 21F-17. *See In the Matter of Anheuser-Busch Inbev SA/NV*, Admin. Proceeding File No. 3-17586 (Sept. 28, 2016), available at https://www.sec.gov/litigation/admin/2016/34-78957.pdf.

The offending language stated:

> [Employee] agrees to keep in strict secrecy and confidence any and all unique, confidential and/or proprietary information and material belonging or relating to [the AB InBev subsidiary] that is not a matter of common knowledge or otherwise generally available to the public including, but not limited to, business, government affairs, communications, financial, trade, technical or technological information. [Employee] acknowledges and agrees that [Employee] remains subject to the "Employment Agreement as to Intellectual Property and Confidentiality," which [Employee] previously signed and is incorporated into the Agreement by reference.
>
> . . . [Employee] agrees not to disclose, directly or indirectly, any information regarding the substance of this Agreement to any person other than [Employee's] spouse, attorney, or financial or tax advisor, except to the extent such disclosure may be required for accounting or tax purposes or as otherwise required by law.

G. Payment in the Context of Ongoing Criminal Investigations.

- Settlement payments premised upon the provision of favorable testimony run afoul of federal and state anti-gratuity laws and the rules of professional conduct.
- In settlement agreements, parties should expressly state that "compensation shall not be paid for testimony in litigation or proceeding."

*1. Federal Anti-Gratuity Statute.*

- Section 201(b) of the federal anti-gratuity statute prohibits the **corrupt** offering or acceptance of anything of value, with the intent to influence, or be influenced in providing, testimony:

> (b) Whoever— . . .
> (3) directly or indirectly, ***corruptly*** gives, offers, or promises anything of value to any person, or offers or promises such person to give anything of value to any other person or entity, with intent to influence the testimony under oath or

> affirmation of such first-mentioned person as a witness upon a trial, hearing, or other proceeding, before any court, any committee of either House or both Houses of Congress, or any agency, commission, or officer authorized by the laws of the United States to hear evidence or take testimony, or with intent to influence such person to absent himself therefrom;
> (4) directly or indirectly, ***corruptly*** demands, seeks, receives, accepts, or agrees to receive or accept anything of value personally or for any other person or entity in return for being influenced in testimony under oath or affirmation as a witness upon any such trial, hearing, or other proceeding, or in return for absenting himself therefrom;
> shall be fined under this title or not more than three times the monetary equivalent of the thing of value, whichever is greater, or imprisoned for not more than fifteen years, or both, and may be disqualified from holding any office of honor, trust, or profit under the United States.

18 U.S.C. § 201(b)(3)-(4) (emphasis added).

- Similarly, Section 201(c) of the federal anti-gratuity statute provides for a lesser punishment in the absence of a "corrupt" scienter:

> (c) Whoever— . . .
> (2) directly or indirectly, gives, offers, or promises anything of value to any person, for or because of the testimony under oath or affirmation given or to be given by such person as a witness upon a trial, hearing, or other proceeding, before any court, any committee of either House or both Houses of Congress, or any agency, commission, or officer authorized by the laws of the United States to hear evidence or take testimony, or for or because of such person's absence therefrom;
> (3) directly or indirectly, demands, seeks, receives, accepts, or agrees to receive or accept anything of value personally for or because of the testimony under oath or affirmation given or to be given by such person as a witness upon any such trial, hearing, or other proceeding, or for or because of such person's absence therefrom;
> shall be fined under this title or imprisoned for not more than two years, or both.

18 U.S.C. § 201(c)(2)-(3).

- *See also Commonwealth v. Miranda*, 934 N.E.2d 222, 229 n.15 (Mass. 2010) ("Compensation to fact witnesses is said to violate the integrity of the judicial system, to undermine the proper administration of justice, and to be contrary to a witness's solemn and fundamental duty to tell the truth.").

2. *Rules of Professional Conduct.*
   - ABA Model Rule of Professional Conduct 3.4(b), which was largely adopted in most jurisdictions, prohibits lawyers from "falsify[ing] evidence, counsel[ing] or assist[ing] a witness to testify falsely, or offer[ing] an inducement to a witness that is prohibited by law."
     - Comment 3 to Rule 3.4 further explains, "The common law rule in most jurisdictions is that it is improper to pay an occurrence witness any fee for testifying . . . ."; *see also* ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 96-402 (1996) ("As long as it is made clear to the witness that the payment is not being made for the substance or efficacy of the witness's testimony, and is being made solely for the purpose of compensating the witness for the time the witness has lost in order to give testimony in litigation in which the witness is not a party, . . . such payments do not violate the Model Rules.").

   - Tex. Prof'l Ethics Comm, Op. No. 614, 398 (Apr. 2012) (explaining that prohibited payments to witnesses include "offering a party in a civil case a settlement on more favorable terms than would otherwise be available in exchange for such party's agreement to give specified testimony in another case"). In Opinion No. 614, the Professional Ethics Committee for the State Bar of Texas provided the following example:

     > [I]f B offers to enter into a particular settlement with A only if A executes an affidavit that is acceptable in content to B, the arrangement constitutes the payment of compensation — in the form of a presumably more favorable settlement to A — in exchange for particular testimony from A to be contained in the affidavit. Participation by B's lawyer in such an arrangement would thus constitute a violation of Rule 3.04(b). There would be a violation even if the testimony contained in the proposed affidavit was entirely truthful. However, it would be permissible under Rule 3.04(b) for the settlement agreement to require simply that A give an affidavit on a specific subject matter without any requirement for approval of the content or specification as to what the specific testimony should be. For example, it

> would be permissible to require that A give an affidavit on A's memories regarding a specific incident (e.g., an automobile accident) as a term of the settlement of the lawsuit between A and B, provided that there was no requirement as to what A's particular memories set out in the affidavit must be and no requirement for approval of the content by B.

- Comment d to Section 117 of the Restatement (Third) of the Law Governing Lawyers further provides, "A witness may not be bribed or offered compensation that is contingent on the witness's testimony or the result in the litigation."

## VII. Extra-Territorial Jurisdiction.

### A. SEC's Enforcement of Dodd-Frank's Provisions.

- Prior to the United States Supreme Court's decision in *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247 (2010), the government brought "extraterritorial" claims under the federal securities laws based on the "conduct and effects" test, which examined whether significant wrongful *conduct* related to the transaction had occurred in the United States, or whether the wrongful conduct had a substantial *effect* in the United States. The "conducts and effects" test was used to determine subject-matter jurisdiction over extraterritorial securities claims.

- In 2010, the Supreme Court rejected the "conduct and effects" test and announced a new "transactional" test for determining federal securities laws' reach, while reaffirming the presumption against applying Congressional legislation extraterritorially. *Morrison*, 561 U.S. at 269. The Court held that the securities laws apply only to alleged misstatements or omissions made "in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States." *Id.* at 273. The Court clarified that the scope of the federal securities laws is not a jurisdictional issue but concerns the substance of the securities statutes.

- One month after the Court issued its decision in *Morrison*, the Dodd-Frank Act was enacted. Section 929P(b) of the Act added language to the Securities Act and the Securities Exchange Act stating that federal district courts "shall have jurisdiction of any action or proceeding brought or instituted by the [SEC] or the United States" which alleged a securities-law violation involving: "*conduct* within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors"; or "conduct occurring outside the United States that has a foreseeable substantial *effect* within the United States."

- Many commentators interpreted the Dodd-Frank Act as restoring the "conduct and effects" test for governmental securities actions. Complicating this matter, however, is the fact that the Dodd-Frank Act was framed in terms of courts' "jurisdiction" over those actions, even though *Morrison* held that the securities laws' extraterritorial scope is not a jurisdictional issue.

- The first case to rule on whether Dodd-Frank restored the "conduct and effects" test was *SEC v. Traffic Monsoon, LLC*, Case No. 2:16-cv-00832-JNP, 2017 WL 1166333 (D. Utah Mar. 28, 2017), which held that notwithstanding *Morrison*, the SEC may bring an enforcement action based on transactions outside the U.S., which involve non-U.S. residents, if sufficient conduct occurred inside the U.S.
    - Traffic Monsoon purportedly provided pay-for-click advertising and offered those who purchased packages a share of the profits. In essence, Traffic Monsoon set up a Ponzi scheme, with the vast majority of transactions occurring outside of the United States and thus, it claimed the SEC could not enjoin foreign actions. The SEC cited Section 929P(b) of the Dodd-Frank Act, which provides:

        > The district courts of the United States and the United States court of any territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or by the United States alleging a violation of [either Section 10(b) of the Securities Exchange Act or Section 17(a) of the Securities Act] involving –
        > (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
        > (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

    - The district court concluded that Congress intended to allow the SEC and the United States to bring securities law claims under the "conduct and effects" test, even though the statute addresses only court jurisdiction and does not otherwise amend the securities laws. Based on the language and legislative history, the court concluded that the provision's purpose is best served by allowing extraterritorial enforcement. An appeal is currently pending before the Tenth Circuit (No. 17-4059, docketed Apr. 17, 2017).

B. Individuals' Extraterritorial Retaliation Claims.

- In *Liu v. Siemens*, 978 F. Supp. 2d 325 (S.D.N.Y. 2013), the U.S. District Court for the Southern District of New York held that the Dodd-Frank Act's

anti-retaliation provision does not apply extraterritorially to protect foreign employees who raise a foreign company's securities violations, if the conduct occurs outside of the United States. In that case, Plaintiff, a Taiwanese citizen who worked for Siemens China, a subsidiary of the German corporation, internally reported what he believed to constitute violations of the Foreign Corrupt Practices Act ("FCPA") that occurred in China and North Korea. The FCPA applied to Siemens because it was listed on the U.S. exchange. After Liu continued to raise issues internally, he was terminated, and he filed suit under the Dodd-Frank Act's anti-retaliation provision, claiming that the provision applied because Siemens was listed on the exchange. The district court cited *Morrison*'s presumption against extraterritorial application, and dismissed his complaint. The court also held that regardless of extraterritoriality, Liu's internal reports implicated the FCPA but did not raise any of the enumerated types of protected activity under the Dodd-Frank Act.

- On appeal, the Second Circuit affirmed. It held that the provision did not apply extraterritorially and determined it need not reach the second issue. *Liu v. Siemens A.G.*, 763 F.3d 181 (2d Cir. 2014). In assessing the anti-retaliation provision's application, the Second Circuit emphasized the contrast between that provision and other Dodd-Frank provisions which expressly provide for extraterritorial application, and noted that "the antiretaliation provision, enjoying no such explicit grant of extraterritorial application, has none." *Id.* at 181.

C. Bounties from the SEC.

- The SEC regulations and the Dodd-Frank Act *do not* restrict the eligibility of a foreign national or U.S. citizen living or working abroad to be a whistleblower. About ten percent of the tips the SEC received during fiscal year 2015 derived from foreign countries, and it awarded the largest award in history (over $30 million) to a whistleblower in a foreign country.

- Despite the holding in *Liu*, the SEC has continued to pay bounties to foreign nationals when there is a "sufficient U.S. territorial nexus." *See* SEC, Order Determining Award Claim, Exchange Act Rel. No. 73174, File No. 2014-10 (Sept. 22, 2014). The SEC has determined that a sufficient territorial nexus exists when: (1) a claimant's information leads to the successful enforcement of an action; (2) brought in the U.S.; (3) concerning violations of U.S. securities laws; (4) by the SEC or another U.S. regulatory agency with the proper enforcement authority.

- While recognizing the Second Circuit's decision in *Liu*, the SEC argues that Dodd-Frank's whistleblower award provisions were drafted to "further the effective enforcement of the U.S. securities laws," as opposed to the anti-retaliation provisions, which are focused on "preventing retaliatory employment actions and protecting the employment relationship." In

maintaining this position, the SEC has forcefully argued that *Liu* is not controlling with respect to the bounty provisions.

D. Extraterritorial Application of SOX.

- In *Villanueva v. Core Labs. NV*, Arb. Case No. 09-108 (ARB Dec. 22, 2011), the plaintiff alleged retaliation after he reported that two foreign companies engaged underreported their income to Columbia tax authorities and thereby violated foreign tax law. The ARB relied upon *Morrison* and held that SOX did not apply extraterritorially, because Section 806(a)(1) did not include extraterritorial laws within its definition of protected activity.

- In *Blanchard v. Exelis Sys. Corp./Vectrus Sys. Corp.*, ARB Case No. 15-031 (Aug. 29, 2017), the ARB applied *RGR Nabisco, Inc. v. European Community,* 136 S. Ct. 2090 (2016),[3] and unanimously held that an ALJ erred in dismissing a SOX claim on the basis that it involved overseas conduct, because SOX, at least in some circumstances, applies to extraterritorial conduct. In *Blanchard*, the complainant worked for a U.S. corporation and reported violations of U.S. laws, including mail and wire fraud, he observed while stationed in Afghanistan. Subsequently, he filed a claim under Section 806, which the ALJ dismissed. On appeal, the ARB reversed. The ARB's majority opinion, authored by Administrative Appeals Judge Joanne Royce, reasoned:

> As explained above, *RGR Nabisco* supports our finding that § 806 contains a clear indication that it applies extraterritorially to cover *all* publically-traded domestic and foreign companies and their employees regardless of the location of the affected employer/employee. This is not to say, however, that § 806 covers all foreign *conduct* of publically-traded foreign companies. The misconduct of a foreign issuer/employer under the statute must still "affect in some significant way" the United States. Blanchard's complaint alleges significant domestic connections as detailed below. Because § 806 applies extraterritorially and Blanchard's allegations do not implicate impermissibly extraterritorial violations, he states a claim under § 806.

*Id.* at *11-12.

However, two of the three administrative appeals judges wrote separate

[3] In *RGR Nabisco, Inc.*, the Supreme Court evaluated whether the Racketeer Influenced and Corrupt Organizations Act (RICO) applied extraterritorially. In making its determination, the Court applied *Morrison* and held that in determining whether Congress affirmatively signaled extraterritorial application, a "clear indication" of extraterritoriality will suffice, and that an "express statement of extraterritoriality is not essential."

concurrences and articulated different rationales, resulting in unclear guidance.

## VIII. <u>Clawback and Forfeiture Provisions.</u>

### A. The Sarbanes-Oxley Act.

- Section 304 of SOX authorized the SEC, at its discretion, to clawback performance-based compensation paid to CEOs and CFOs of public companies when those companies must prepare accounting restatements "due to the material noncompliance of the issuer, as a result of misconduct." 15 U.S.C. § 7243.

- In *SEC v. Jensen*, 855 F.3d 1100 (9th Cir. 2016), the Ninth Circuit held that the SOX clawback applies even when the "misconduct" involved was not the personal misconduct of the CEO or CFO but of lower-level employees. It held that Rule 13a-14 provided the SEC with a cause of action against CEOs and CFOs who did not file the requisite certifications, as well as CEOs and CFOs who certified false or misleading statements.
    - The Ninth Circuit explained that "it is the issuer's misconduct that matters, and not the personal misconduct of the CEO or CFO" in triggering SOX's disgorgement provision.

- This opinion aligned with rulings by several district courts that to trigger the clawback, CEOs or CFOs need not engage in wrongdoing or have any causal connection to the misconduct. *See, e.g.*, *SEC v. Baker*, No. A-12-CA-285-SS, 2012 WL 5499497 (W.D. Tex. Nov. 13, 2012); *SEC v. Microtune*, Inc., 783 F. Supp. 2d 867 (N.D. Tex. 2011); *SEC v. Jenkins*, 718 F. Supp. 2d 1070 (D. Ariz. 2010).

### B. The Dodd-Frank Act.

- Section 954 of the Dodd-Frank Act requires publicly traded companies to develop and disclose clawback provisions to recover incentive-based monies paid to their executive officers when the company must restate previously issued financial statements due to material noncompliance with financial reporting requirements under the securities laws.
- When the clawback is triggered, it enables the company to recover a current or former executive's incentive-based compensation from up to three years before the accounting restatement is required, for an excess that would not have been provided under the corrected statement.
- Like SOX's clawback provision, a covered executive's misconduct need not be proven.
- Section 956 of the Dodd-Frank Act required six agencies (the SEC, National Credit Union Administration, the Office of the Comptroller of the Currency,

the FDIC, FHFA, and Board of Governors of the Federal Reserve System) to issue joint regulations prohibiting certain incentive-based payment arrangements at financial institutions, because the arrangements inappropriate risk-taking. Those arrangements include excessive incentive-based payment arrangements or arrangements that could otherwise lead to material financial loss.

- On July 1, 2015, the SEC released Proposed Rule 10D-1 to implement Section 954 of the Dodd-Frank Act, but following the comment period, the rule was not finalized. In 2016, five of the six agencies (all but the SEC) approved a joint proposed rule, which has not yet been finalized. For a comprehensive analysis of those proposals, see Shearman & Sterling, LLP, *The Re-Proposed Rule on Incentive-Based Compensation at Financial Institutions: Overview and Observations* (May 5, 2016).

    - Under the 2016 proposal, the covered institutions include a wider breadth of financial institutions, such as banks, investment advisers, broker-dealers, and credit unions, with an average of at least $1 billion in total assets, although more rigorous limits apply to institutions with more than $50 billion in total assets (Level 2), and even greater requirements apply to those with assets in excess of $250 billion (Level 1).

        1. *<u>Level 3 Requirements ($1 - $50 billion in assets):</u>*

            - Must maintain records documenting incentive-based compensation arrangements and ensure the arrangements: (1) appropriately balance risk and financial rewards; (2) are compatible with effective risk management and controls; and (3) are supported by effective governance.

        2. *<u>Level 1-2 Requirements: Deferral, Clawback, and Forfeiture/ Downward Adjustments:</u>*

            - Incentive-based income paid to “senior executive officers” and “significant risk takers” is subject to a seven-year clawback.
            - A “significant risk taker” is “not a senior executive officer but was among the top 5 percent (for organizations with more than $250 billion in consolidated assets) or top 2 percent (for organizations with between $50 and $250 billion in consolidated assets) of most highly compensated covered persons in the entire consolidated organization; or (2) had authority to commit or expose 0.5 percent or more of the capital of a covered institution.”

- **Deferral.** Requires companies to defer large amounts of incentive-based income for the covered individuals to offset the risk of erroneous awards, by making the income subject to future reductions, whether or not it is specifically related to the period in which the triggering event occurred.
  - Required vesting schedules will impact executives' negotiated separations, as will the mandatory deferrals, under which vested but undistributed income is still subject to forfeiture.

- **Forfeiture/downward adjustments.**

  Triggering events:
  - Poor financial performance attributable to a significant deviation from the covered institution's risk parameters;
  - Inappropriate risk-taking, regardless of the impact on financial performance;
  - Material risk management or control failures;
  - Non-compliance with statutory, regulatory, or supervisory standards that results in either an enforcement or legal action brought by a federal or state regulator or agency, or a restatement of a financial statement to correct a material error; and
  - Other aspects of conduct or poor performance as defined by the covered institution.

  Forfeiture/downward adjustment *reviews* are mandatory, as are factors the covered institutions must consider, but decisions to implement forfeiture/downward adjustments are discretionary.

- **Clawbacks.** Enable covered institutions to recover vested incentive-based compensation from a senior executive officer or significant risk-taker upon occurrence of a triggering event.

  Triggering events: Conduct that resulted in significant financial or reputational harm to the covered institution, fraud, or intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker's incentive-based compensation.
  - **Time period**: Covered institution may recover incentive-based compensation from a current or former senior executive officer or significant risk-taker for seven years following the date on which

such compensation vests.

- Once a triggering event occurs, all incentive-based compensation is subject to the clawback, regardless of whether it is causally or temporally related to the triggering event.
- Generally, covered entities are not required to clawback compensation following a triggering event, but are required to complete a review to assess whether to implement the provision.

## IX. **Regulatory References in the United Kingdom.**

- The Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) introduced new rules in March 2016 for investment firms, deposit takers, and insurers subject to the senior managers regimes governing the banking (Senior Managers and Certification Regime) and insurance (Senior Insurance Managers Regime) industries. The rules went into effect in March 2017 and implemented a compulsory form of regulatory reference for employees who move positions between firms, with the intent of enabling companies to make educated recruiting decisions.
- The FCA's final policy is set forth in FCA, Strengthening Accountability in Banking & Insurance: Regulatory References Final Rules, PS1622 (Sept. 2016), *available at* https://www.fca.org.uk/publication/policy/ps16-22.pdf.
- The PRA's final policy is set forth in PRA, Strengthening Accountability in Banking & Insurance: PRA Requirements on Regulatory References (Part II), PS2716 (Sept. 2016), *available at* www.bankofengland.co.uk/pra/Documents/publications/ps/2016/ps2716.pdf.

Highlights:

- Banks and insurers must take reasonable steps to obtain references for covered candidates' past six years of employment.
- The rules provide a mandatory reference template, which was revised from the original draft.
- Mandatory disclosures include: a list of all roles held and description of responsibilities; any breaches of the FCA's or PRA's conduct rules or standards; the details surrounding the issuance of any formal written warning, suspension, dismissal, reduction, or recovery of remuneration; and all other information relevant to a candidate's fitness and propriety.
- Common law duty to exercise reasonable care in ensuring information provided in references is true, accurate, and fair.
- Updated regulatory references must be provided to current employers when new information arises that would have caused a prior employer to provide a significantly different reference regarding the candidate's fitness and propriety than it provided under the information it had at the time.
- Firms cannot enter into agreements with employees, such as severance or settlement agreements, that restrict an employer's disclosures on regulatory references.

## X. Defend Trade Secrets Act of 2016 and Use of Confidential Information in Pursuit of Claims.

- The Defend Trade Secrets Act of 2016 ("DTSA"), codified at 18 U.S.C. § 1831 *et seq*., provides certain immunities and protections for whistleblowers' use of employers' trade secrets during their protected activity.

- **Immunity.** DTSA provides that an individual may not be held criminally or civilly liable under any federal or state trade secret law for the disclosure of a trade secret: (1) made in confidence to a federal, state, or local government official, either directly or indirectly, or to an attorney, solely for the purpose of reporting or investigating a suspected violation of law; or (2) made in a complaint or other document filed in a lawsuit or other proceeding, if such filing is made under seal. 18 U.S.C. §1833(b)(1).
    - The DTSA also provides immunity when a whistleblower reveals an employer's trade secret in the context of an anti-retaliation lawsuit under 18 U.S.C. § 1833(b)(1). 18 U.S.C. § 1833(b)(2).

- **Notice.** Employers must: (1) provide notice of the immunity in their agreements with employees and contractors covering trade secrets and confidentiality, 18 U.S.C. § 1833(b)(3)(A); or (2) cross-reference a policy document provided to the employee that sets forth the employer's reporting policy for a suspected violation of law, 18 U.S.C. § 1833(b)(3)(A).
    - When an employer fails to comply with the notice provision, it foregoes exemplary damages and attorneys' fees otherwise available under 18 U.S.C. § 1836(b)(3)(C)-(D) in cases of willful and malicious misappropriation. 18 U.S.C. § 1833(b)(3)(C).

- **Injunctions**. The DTSA prohibits injunctions that "prevent a person from entering into an employment relationship." Even if an employee misappropriates trade secrets and discloses them to a competitor, under the DTSA, the employee cannot be enjoined from working for the competitor. However, certain restrictions may be placed on the employment relationship, provided they are "based on evidence of threatened misappropriation and not merely on the information the person knows." 18 U.S.C. § 1836(b)(3)(A)(i)(I).

- **Use of Confidential Employer Documents**. In *Erhart v. BofI Holding, Inc.*, No. 15-CV-02287-BAS-NLS, 2017 WL 588390 (S.D. Cal. Feb. 14, 2017), an internal auditor for a financial services company discovered wrongful conduct, which he reported to the U.S. Department of the Treasury's Office of the Comptroller of the Currency. Subsequently, he filed a lawsuit alleging retaliation under federal and California state provisions. Bofl countersued him for accessing its proprietary information on his personal computer and on his girlfriend's personal computer, for forwarding it to his mother, and for downloading it on a portable USB drive. In response to Bofl's claims for breach of contract, conversion, breach of the duty of loyalty, negligence, fraud, unfair business practices, and violation of the California Penal Code and the Computer Fraud and Abuse Act, Erhart asserted fifty-two affirmative defenses, and

BofI moved for summary judgment on the thirteen defenses related to whistleblower protections.

The district court struck Erhart's affirmative defenses which were duplicative or which cited laws that did not contain express whistleblower protections, but it did not strike his defenses under SOX, the Dodd-Frank Act, the Consumer Financial Protection Act, the Bank Secrecy Act, the Financial Institutions Reform, Recovery, and Enforcement Act, the California Labor Code, or common-law public policy. The court emphasized that even though Erhart entered into a confidentiality agreement with BofI regarding its proprietary information, public policy counseled *against* enforcement of the agreement, because he used the information to report suspected wrongdoing to the government, his conduct constituted protected activity, and enforcement of the agreement would violate SEC Rule 21F-17.

Insofar as Erhart appropriated BofI files for personal use, the court determined that he did not engage in a "wholesale stripping of [BofI]'s confidential documents," or that his appropriation was "vast and indiscriminate." The court declined to dismiss his affirmative defenses to BofI's misappropriation claim because Erhart: (1) "was very careful in [selecting] the information [he] accessed and turned over"; (2) submitted only documents that "specifically related to one of the allegations of wrongdoing [he] had discussed with [his supervisor] and then reported to federal law enforcement"; and (3) submitted only documents he "had properly accessed in the course of performing [his] work as an internal auditor." *Id.* at *13. Instead, the court held that a genuine issue of material fact existed about whether his removal of documents was "reasonably necessary" to support his allegations of wrongdoing.

With respect to a spreadsheet Erhart emailed to his mother and information he accessed from his girlfriend's laptop, the court also declined to dismiss Erhart's affirmative defenses. His declaration stated that he emailed the spreadsheet to his mother only for safekeeping, as he had been advised that BofI broke into the locked cabinets and computer at his work station and accessed his work laptop remotely. Because a jury could conclude that "the information transmitted by Erhart was relevant to his whistleblower reports, that this information was transmitted because he had a reasonable concern the information might be destroyed, and that Erhart's motivation for forwarding the information was to support his allegations of wrongdoing," the court determined that the defenses survived summary judgment; under the circumstances advanced by Erhart, public policy would weigh in his favor. *Id.* at *14-15.

Finally, with respect to confidential information Erhart disclosed in his publicly filed whistleblower lawsuit, the court held that an issue of fact existed: if the disclosures were "reasonably necessary" to establish a plausible claim of employer wrongdoing or to otherwise support his clams of protected activity, public policy favored the protection of such disclosures. *Id.* at *15.

Subsequently, Erhart filed a first amended complaint, and BofI filed a motion to strike

twenty-six paragraphs, which it alleged violated confidentiality. The court denied that motion to strike and explained, "this Court has already determined Erhart was permitted to disclose BofI's information in his complaint if doing so was 'reasonably necessary' to pursue his retaliation claim." *Erhart v. BofI Holding, Inc.*, No. 15-CV-02287-BAS-NLS, 2017 WL 4005434, at *19-20 (S.D. Cal. Sept. 11, 2017).

- In the context of the False Claims Act, *United States ex rel. Ruhe v. Masimo Corp.*, 929 F. Supp. 2d 1033 (C.D. Cal. 2012), addressed an employee's alleged violation of a non-disclosure agreement. In *Ruhe*, two relators filed a *qui tam* action against Masimo, which sold non-invasive hemoglobin measurement devices to the government. Masimo filed a motion to strike two exhibits attached to the complaint, contending that they contained scandalous and impertinent matter because the relators took the documents from their former employer in violation of their non-disclosure agreements. The district court denied the motion and cited "the strong public policy in favor of protecting whistleblowers who report fraud against the government." *Id.* at 1038. The court explained, "Obviously, the strong public policy would be thwarted if Masimo could silence whistleblowers and compel them to be complicit in potentially fraudulent conduct. . . Such an exemption is necessary given that the FCA requires that a relator turn over all material evidence and information to the government when bringing a *qui tam* action." *Id.* The court further emphasized that the exhibits were not "impertinent," because they "contain[ed] information about the accuracy of the devices at issue in the action . . . [which] [was] directly relevant to [r]elators' allegations." *Id.*

    - In fact, in *qui tam* actions, relators must disclose to the government documents evidencing fraudulent activity. "A copy of the complaint and written disclosure of substantially all material evidence and information the person possesses shall be served on the Government pursuant to Rule 4(d)(4) of the Federal Rules of Civil Procedure." 31 U.S.C. § 3730(b)(2) (internal footnote omitted); *see also United States v. Cancer Treatment Ctrs. of Am.,* 350 F. Supp. 2d 765, 773 (N.D. Ill. 2004) (finding that an employee's confidentiality agreement with an employer "cannot trump the FCA's strong policy of protecting whistleblowers who report fraud against the government . . . Relator could have disclosed the documents to the government under any circumstances, without breaching the confidentiality agreement.").

- *But see JDS Uniphase Corp. v. Jennings*, 473 F. Supp. 2d 697, 698 (E.D. Va. 2007). In *JDS Uniphase Corp.*, an employer sued its former employee for breaching its proprietary information agreement (PIA), and the employee filed a counterclaim which alleged that JDS retaliated against him in violation of SOX. The employee asserted that pursuant to California law, public policy weighed against enforcing the PIA. The court distinguished between employees who "*orally* disclos[e] proprietary information to her counsel in preparation for suit against the employer," when such disclosure are necessary to vindicate legal rights, from employees who "physically cart[ed] away stacks of documents, disks, or computers belonging to the business

without authorization to do so and in contravention of a confidentiality agreement." *Id.* at 703-04. In so holding, the district court emphasized the difference between disclosing oral information and documentary evidence, and between making disclosures necessary to vindicate legal rights and overly broad disclosures.

- Similarly, in *United States ex rel. Cafasso v. Gen. Dynamics C4 Sys., Inc.*, 637 F.3d 1047 (9th Cir. 2011), the Ninth Circuit affirmed the district court's grant of summary judgment for the employer on its breach of confidentiality agreement claim. Although the employee violated the agreement in procuring confidential documents to provide the government in support of her *qui tam* action, the court found her conduct unprotected. The Ninth Circuit explained that even if it were to adopt a public policy exception to breach of contract claims for relators, the relator's conduct would not fall within the exception in this case because she engaged in a "vast and indiscriminate appropriation" of the employer's files. She copied "tens of thousands of pages" in an "unselective taking of documents," including attorney-client privileged documents, and she "scanned only file names and did not look at any individual documents at all." *Id.* at 1061-62. The court continued, "Were we to adopt a public policy exception to confidentiality agreements to protect relators—a matter we reserve for another day—those asserting its protection would need to justify why removal of the documents was reasonably necessary to pursue an FCA claim" because "[t]he need to facilitate valid claims does not justify the wholesale stripping of a company's confidential documents." *Id.* at 1062.

## XI. <u>Indemnification.</u>

- U.S. Deputy Attorney General Larry D. Thompson's Memorandum (2003): In considering whether a company cooperated with the federal government for purposes of making charging decisions against the company, prosecutors could consider "whether the corporation appears to be protecting its culpable employees and agents [including] a corporation's promise of support to culpable employees and agents, either *through the advancing of attorneys fees,* through retaining the employees without sanction for their misconduct, or through providing information to the employees about the government's investigation pursuant to a joint defense agreement . . . ."

    - Interpreted by many attorneys to mean that corporations could curry favor with the government if they cut off individual employees' rights to indemnification and legal fees.
    - *U.S. v. Stein*, 541 F.3d 130 (2d Cir. 2008): The government prosecuted several firm employees for accounting fraud pursuant to the Thompson Memorandum. The accounting firm hired counsel who conferred with the AUSAs, and the AUSAs made clear that it disfavored the firm's advancement of legal fees to employees who the government perceived were not cooperating with its investigation. To prevent the firm from being indicted, the firm's counsel restricted the advancement of fees in ways it never did historically, by: (1) placing a $400,000 cap on fees per

employee; (2) conditioning the receipt of fees on the employee's cooperation with the government; and (3) terminating employees, and therefore the advancement of fees to them, upon indictment. Ultimately, the trial court dismissed the indictments against the individuals because the federal government forced the firm to deny them legal fees in order to receive favorable treatment, which amounted to a violation of their Sixth Amendment right to counsel. The Second Circuit affirmed.

- U.S. Deputy Attorney General Paul J. McNulty's Memorandum (2006): The Department of Justice revised its corporate charging guidelines for federal prosecutors throughout the country. The McNulty memorandum instructed prosecutors that they generally could not consider a corporation's advancement of attorneys' fees to employees when making a charging decision, but further stated, "A rare exception is created for those extraordinary instances where the advancement of fees, combined with other significant facts, shows that it was intended to impede the government's investigation. In those limited circumstances, fee advancement may be considered only if it is authorized by the Deputy Attorney General."

- Deputy Attorney General Mark Filip's Memorandum (2008): The Filip Memorandum expounded on the exception in the McNulty memorandum for circumstances under which the advancement of attorneys' fees can be considered in making a charging decision, following the *Stein* decision. It stated that in assessing a corporation's cooperation:

  > Prosecutors should not take into account whether a corporation is advancing or reimbursing attorneys' fees or providing counsel to employees, officers, or directors under investigation or indictment. Likewise, prosecutors may not request that a corporation refrain from taking such action. This prohibition is not meant to prevent a prosecutor from asking questions about an attorney's representation of a corporation or its employees, officers, or directors, where otherwise appropriate under the law. Neither is it intended to limit the otherwise applicable reach of criminal obstruction of justice statutes such as 18 U.S.C. § 1503. If the payment of attorney [fees] were used in a manner that would otherwise constitute criminal obstruction of justice—for example, if fees were advanced on the condition that an employee adhere to a version of the facts that the corporation and the employee knew to be false—these Principles would not (and could not) render inapplicable such criminal prohibitions.

- Deputy Attorney General Sally Q. Yates Memorandum (2015): The Yates Memorandum increased the government's targeting of individuals within corporations and emphasized its unwillingness to dismiss claims against individuals. It increased the amount and depth of information corporations need to provide the government about culpable individuals in order to be deemed cooperative for purposes of charging decisions.

- Resulted in increased investigations of individuals.
- Created a conflict of interest between individuals and corporations, such that individuals seek to have independent counsel more often, which in turn, increased their reliance on indemnification and the advancement of attorneys' fees.

- On September 14, 2017, Deputy Attorney General Rod Rosenstein announced that the Yates Memorandum is "under review" and that the DOJ will announce a revised policy in the "near future." Rosenstein also said, "The issue is can you effectively deter corporate crime by prosecuting corporations or do you in some circumstances need to prosecute individuals. I think you do." *See* Josh Gerstein, "Rosenstein Signals Changes Coming on Corporate-Crime Prosecution Policy" POLITICO (Sept. 14, 2017), *available at* http://www.politico.com/blogs/under-the-radar/2017/09/14/corporate-crimes-prosecutions-rod-rosenstein-242721.