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Publicly Traded Health Care Entities at Risk from New SEC Whistleblower Incentives and Protections in Dodd-Frank Act

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Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") brings a new round of sweeping reform to our nation's financial system. The Act requires regulatory agencies to conduct over 50 studies of the financial system and implement more than 250 instances of rulemaking. Some of these new measures are expected to create substantial new enforcement and litigation risks, as well as heightened compliance burdens and costs for publicly-traded pharmaceutical companies and medical device manufacturers, among other healthcare industry entities.

Expanded (and New) Bounty Hunter Provisions: A Sea Change for SEC and CFTC Enforcement Actions

One result of the Bernie Madoff scandal,[2] in which the U.S. Securities Exchange Commission ("SEC" or "Commission") was embarrassed for its publicized failure to timely and properly investigate the largest Ponzi scheme in recent history, is that Congress added revolutionary "bounty hunter" provisions to the Act.[3] These provisions are designed to increase the voluntary reporting of securities and commodities violations. Congress did so by significantly enhancing existing whistleblower rewards and protections. [4]

The new whistleblower provisions appear in two main parts – section 922 (related to the SEC) and section 748 (related to the U.S. Commodity Futures Trading Commission, or "CFTC"). Both provisions offer a bounty of up to 30 percent of collected monetary sanctions over $1 million recovered by the SEC, the CFTC, the U.S. Department of Justice ("DOJ"), self-regulatory organizations, and other regulators. Congress instructed that the necessary rules to implement these measures must be promulgated within 270 days of the statute's enactment.

Under the Act, a whistleblower who provides "original information" to the SEC or CFTC[5] which results in a successful enforcement action in which monetary sanctions over $1 million are imposed is eligible for a reward of between 10 percent and 30 percent of the funds collected as sanctions. This threshold dollar limit for bounty eligibility should not be hard to meet in light of the magnitude of fines and penalties the Commission has imposed in recent years in enforcement actions;[6] moreover, it should help to minimize the number of lesser matters from being reported. A recent example of how the bounty provisions may affect publicly traded healthcare companies that is worth noting is the *Pequot* matter,[7] in which the SEC recently paid a whistleblower a reward of $1 million (albeit under the old whistleblower provisions).

The Act's new bounty hunter provisions are somewhat similar to (but appear easier to meet than) the *qui tam* whistleblower provisions of the federal False Claims Act ("FCA"), which the DOJ reports has led to the recovery of $2.4 billion during 2009, and more than $24 billion since 1986. The FCA whistleblower actions have demonstrably increased the number of agency enforcement proceedings in the healthcare industry, where most enforcement actions reported during 2009 relate to actions initiated by whistleblowers.

A few categories of individuals are excluded by the Act from qualifying for the new bounty hunter provisions:

- individuals who work for regulatory agencies, including the SEC, CFTC and DOJ;
- auditors who conduct a required audit of the publicly traded company; and
- individuals convicted in a proceeding related to the judicial or administrative action for which the whistleblower otherwise could receive an award.

Clearly, potential whistleblowers under the Act are not limited to current or former employees. They can be independent contractors, consultants, joint venture partners, sales agents, accountants (so long as they are not conducting a required audit), as well as others whose dealings with a company puts them in a position where they can gather and provide original information to government officials in the hope of being financially rewarded.

The "plaintiffs' bar" now handling *qui tam* work under the FCA expectedly will take advantage of these new whistleblower provisions. (Already some firms are advertising for these clients.).[8] It appears that it

should be much easier for whistleblowers to seek bounties under the Act's provisions because, unlike the FCA's *qui tam* provisions, whistleblowers under the Act need not file and maintain lawsuits in federal court. Consequently, they do not have to incur the significant financial burdens that *qui tam* relators and their counsel must shoulder under the FCA. The Commission is supposed to be enacting rulemaking that sets out prescribed procedures and forms to be used, but in the meantime it appears that so long as the whistleblower provides original information and is not otherwise disqualified from eligibility to receive a bounty from the agency, then the person is eligible to receive such an award. In addition, the new bounty hunters do not have to meet the heightened pleading standards imposed by Federal Rule of Civil Procedure 9(b) for suits pleading fraud claims.

Recent FCPA Enforcement

One enforcement interest that appears to be ripe for exploitation by these new bounty hunters is the Foreign Corrupt Practices Act ("FCPA"). Because pharmaceutical manufacturers increasingly are multinational companies or conduct some drug testing and marketing activities outside the United States, the FCPA provisions which are incorporated into the Securities Exchange Act pose significant liability concerns. Violations of the FCPA's accounting and financial control provisions, or its anti-bribery provisions, can lead to civil and criminal liability—and significant fines and penalties.

The Act's whistleblower provisions take effect at a time when the DOJ and SEC have substantially increased the amount of resources devoted to FCPA matters. The SEC has added new FCPA enforcement units, while the DOJ has added prosecutors and FBI agents dedicated to FCPA cases – and is filling additional positions. Mary Shapiro, Chairman of the SEC, recently testified that "The President is requesting a total of $1.258 billion for the agency in FY 2011, a 12 percent increase over the FY 2010 funding level. If enacted, this request would permit us to hire an additional 374 professionals, a 10 percent increase over FY 2010."[9] With the Act's passage, Ms. Schapiro revised that number upward, testifying that the agency needs about 800 new positions to meet the new and expanded responsibilities required under the Act. The DOJ has also begun discussions with the IRS Criminal Investigation Division about partnering on FCPA cases around the United States. Moreover, the federal agencies have started to use extensive undercover techniques to uncover FCPA violations.

In a recently publicized FCPA investigation, the DOJ used undercover law-enforcement techniques to uncover allegedly widespread fraud and corruption – which resulted in 22 executives and employees of companies in the military and law-enforcement products industry being charged for their involvement in schemes to bribe foreign government officials.[10] In 2010, the DOJ's Fraud Section has charged a record number of individuals and entities with FCPA or bribery-related offenses.[11] And this year may surpass the record set in 2009, when more individuals were charged with FCPA violations than in any prior year (or in the past several years combined)—including CEOs, CFOs and other senior corporate, sales, marketing and finance executives.

Assistant U.S. Attorney General Lanny Breuer, in charge of the DOJ's Criminal Division, has warned that "the prospect of significant prison sentences for individuals should make clear to every corporate executive, every board member, and every sales agent that we will seek to hold you *personally accountable* for FCPA violations. " It is anticipated that the new whistleblower provisions will soon increase the number of FCPA matters—already at all-time-high levels—and will also increase other types of securities and commodities fraud investigations and prosecutions.

New Whistleblower Protections

While it is challenging for employers to determine how to best handle whistleblowing employees, the Act has added another layer of enhanced whistleblower protections. Under the Act, a whistleblower now can sue a retaliating employer directly in federal court without first having to exhaust administrative remedies. In addition, existing whistleblower protections under the Sarbanes-Oxley Act have been clarified to apply to *both* parent companies and affiliates whose financial information is included in consolidated financial statements.

Aiding and Abetting Liability Authorized for SEC Enforcement Actions

The Act also includes provisions designed to make it easier for the SEC to bring and maintain enforcement actions based on expanded secondary liability. The following new provisions set out the newly expanded authority:

- Section 929M (Aiding and abetting authority under the Securities Act and the Investment Company Act);
- Section 929N (Authority to impose penalties for aiding and abetting violations of the Investment Advisers Act);
- Section 929O (Aiding and abetting standard of knowledge satisfied by recklessness).

Although the Private Securities Litigation Reform Act of 1995[12] authorized the SEC to charge aider and abettor violations of the Exchange Act in enforcement actions, Congress had required the SEC to demonstrate that defendant(s) knew about the misconduct, which courts interpreted as requiring proof of

demonstrate that defendant(s) knew about the misconduct, which courts interpreted as requiring proof of actual knowledge (and not just recklessness). While a few senators had strongly supported extending to private litigants the authority to charge and prove secondary aiding and abetting liability in federal securities fraud cases, Congress did not do so in the Act, although it may in the future. Section 929Z of the Act instructs the U.S. Comptroller General to "conduct a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws, " and then report to Congress on its findings within a year.

Similarly, while Congress did not provide private litigants with the same authority as the SEC obtained in the Act (see below) regarding the extraterritorial reach of the federal securities laws in securities fraud actions (*i.e.*, legislatively repealing *Morrison v. National Australia Bank*), it also instructed that a study on this issue be conducted. Section 929Y of the Act instructs the SEC to solicit public comments, conduct the study, and then provide it to Congress, along with recommendations, within 18 months.

Extraterritorial Reach (Limited Repeal of *Morrison*) for SEC Enforcement Actions

Section 929P(b) of the Act effectively repeals *Morrison v. National Australia Bank*[13] for certain SEC enforcement actions. It authorizes extraterritorial jurisdiction if the SEC charges violations of the antifraud provisions of the federal securities laws that involve "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. "

What This Means for Publicly Traded Healthcare Companies

In light of the new and potentially sweeping consequences that may result if these new laws are violated – and since publicly traded companies may face many other issues, such as continued participation in government programs; collateral civil litigation; and obligations to shareholders, employees, customers and the public—companies may wish to thoroughly review their existing corporate governance and compliance policies.

Companies may also want to take actions to encourage and enhance the general loyalty of their employees and agents, and to encourage informing the company of potential problems. This may discourage employees from quietly working with the government and plaintiffs' counsel in the hope of recovering huge bounties at the company's expense. Legal counsel may provide the necessary perspective and skills, including how to appropriately structure and handle internal investigations, if necessary.[14] It is likely to be more cost-effective to be proactive than reactive. Today, regulators and the public do not appear too willing to tolerate mistakes, honest or not.

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Mr. Clark frequently writes and presents on antitrust, corporate compliance and governance, ethics, internal investigations, pharmaceutical law, securities law and white-collar defense issues. As an adjunct law professor at the Health Law & Policy Institute of the University of Houston Law Center, Mr. Clark has taught on food and drug law, civil and criminal trial advocacy, healthcare and antitrust, and regulation of biomedical research. He is also a faculty instructor for the National Institute for Trial Advocacy. He is the Editor-in-Chief of Pharmaceutical Law: Regulations of Research, Development, and Marketing (BNA/ABA Section of Health Law 2007).

2 The legislation was signed into law by President Obama on July 21, 2010. Section 922 of the Dodd-Frank Act provides, in relevant part:

(a) In General- The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 21E the following:

SEC. 21F. SECURITIES WHISTLEBLOWER INCENTIVES AND PROTECTION.

(a) Definitions- In this section the following definitions shall apply:

(1) COVERED JUDICIAL OR ADMINISTRATIVE ACTION- The term 'covered judicial or administrative action' means any judicial or administrative action brought by the Commission under the securities laws that results in monetary sanctions exceeding $1,000,000.

(2) FUND- The term 'Fund' means the Securities and Exchange Commission Investor Protection Fund.

(3) ORIGINAL INFORMATION- The term 'original information' means information that—(A) is derived from the independent knowledge or analysis of a whistleblower;

(B) is not known to the Commission from any other source, unless the whistleblower is the original source of the information; and

(C) is not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information.

(4) MONETARY SANCTIONS- The term 'monetary sanctions', when used with respect to any judicial or administrative action, means—

(A) any monies, including penalties, disgorgement, and interest, ordered to be paid; and

(B) any monies deposited into a disgorgement fund or other fund pursuant to section 308(b) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7246(b)), as a result of such action or any settlement of such action.

(5) RELATED ACTION- The term 'related action', when used with respect to any judicial or administrative action brought by the Commission under the securities laws, means any judicial or administrative action brought by an entity described in subclauses (I) through (IV) of subsection (h)(2)(D)(i) that is based upon the original information provided by a whistleblower pursuant to subsection (a) that led to the successful enforcement of the Commission action.

(6) WHISTLEBLOWER- The term 'whistleblower' means any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission.

(b) Awards-

(1) IN GENERAL- In any covered judicial or administrative action, or related action, the Commission, under regulations prescribed by the Commission and subject to subsection (c), shall pay an award or awards to 1 or more whistleblowers who voluntarily provided original information to the Commission that led to the successful enforcement of the covered judicial or administrative action, or related action, in an aggregate amount equal to—(A) not less than 10 percent, in total, of what has been collected of the monetary sanctions imposed in the action or related actions; and

(B) not more than 30 percent, in total, of what has been collected of the monetary sanctions imposed in the action or related actions.

Section 21A(e) of the Securities Exchange Act of 1934 had a little-used whistleblower incentive provision which only authorized bounties to whistleblowers in insider trading cases.

The legislation defines *original information* to mean "information that – "(A) is derived from the independent knowledge or analysis of a whistleblower; (B) is not known to the Commission from any other source, unless the whistleblower is the original source of the information; and (C) is not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information. " See Dodd-Frank Act § 748 (amending the Commodity Exchange Act, 7 U.S.C. § 1*et seq.*) and Dodd-Frank Act § 922 (amending the Securities Exchange Act of 1934, 15 U.S.C. 78a*et seq.*).

3 *See generally* " Madoff's investment scandal highlights SEC's struggles to keep up with the markets" at http://www.dallasnews.com/sharedcontent/dws/bus/stories/DN-maedoffSEC_22bus.ART.State.Edition1.9cb1054.html (describing in some detail the Ponzi scheme involving former NASDAQ chairman Bernard Madoff which he confessed to in 2008).

4 *See generally* SEC Annual Report (2009), *available at* http://www.sec.gov/about/secpar/secpar2009.pdf#2009review.

5 *See* "SEC Awards $1 Million for Information Provided in Insider Trading Case," Lit. Release No. 21601 (July 23, 2010) (Press release discussing *Securities and Exchange Com'n v. Pequot Capital Management, Inc*., et al., No. 3:10-CV-00831-CVD (D. Conn., Complaint filed May 27, 2010)). As the Commission noted,

6 The SEC approved the award earlier this week pursuant to Section 21A(e) of the Securities Exchange Act of 1934, which authorized the Commission, in its discretion, to grant an award of up to 10% of the penalties paid in a case to a person who provided information leading to the imposition of those penalties, but *only in insider trading cases. That provision has since been repealed by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added new Section 21F to the Securities Exchange Act, authorizing the Commission to award bounties to parties who provide information leading to recovery of monetary sanctions in a broader range of cases, not limited as before to civil penalties recovered in insider trading cases.*

7 *Id.* (emphasis supplied).

8 Using the search expression "SEC whistleblower" on Google returned several banner advertisements from plaintiffs' firms, including links to firms known for their qui tam work such as Phillips and Cohen. In addition, plaintiffs' class action firms are getting involved, such as Milberg. See " Milberg Expands Practice to Include Representation of Securities Fraud Whistleblowers " at http://cases.milberg.com/whistleblower/.

9 See Mary Shapiro, Testimony Concerning Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges, Before the U.S. House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises (July 20, 2010), *available at*http://www.sec.gov/news/testimony/2010/ts072010mls.htm.

10 *See* DOJ, " Twenty-Two Executives and Employees of Military and Law Enforcement Products Companies Charged in Foreign Bribery Scheme" (Jan. 19, 2010)(noting this is the largest FCPA case ever filed and involved the unsealing of 16 indictments, along with the execution of 14 search warrants across

the United States, as well as seven search warrants executed by the United Kingdom's City of London Police in its own investigation of the foreign bribery conduct).

[11] *See generally* Gibson Dunn, " 2010 Mid-Year FCPA Update" (July 8, 2010), *available at*http://www.gibsondunn.com/publications/pages/2010Mid-YearFCPAUpdate.aspx .

[12] The PSLRA is codified as amended at 15 U.S.C. § 78u–4 et seq. As I've explained elsewhere, "[b]y 1995, Congress had grown so concerned about abusive securities fraud strike suits that it enacted the … [PSLRA] and included various provisions to prevent marginal class action suits from continuing to be used as a settlement vehicle by contingency fee counsel." Michael E. Clark, *Securities Law Issues and Disclosure Considerations, Cha. 12, VII, p. 789,* Pharmaceutical Law: Regulation of Research, Development, and Marketing (BNA 2007) (internal citations omitted). Congress included heightened pleading standards in the PSLRA: the complaint must set forth each statement alleged to be misleading, reasons why it is misleading, and if it involved an omission, all facts upon which the belief was formed that the statement was misleading (15 U.S.C. § 78u-4(b)(1); moreover, the complaint must state with particularity the facts that give rise to a strong inference that defendant acted with the required state of mind as to each act or omission alleged to violate the securities laws (15 U.S.C. § 78u-4(b)(2). *See id*. at 790. Yet another important feature of the PSLRA is the automatic stay of discovery provision (15 U.S.C. § 78u-4(b)(3)(B)) pending the court's determination of a motion to dismiss. *Id*.

[13] 561 U.S. __ , No. 08-1191 (June 24, 2010).

[14] Even if a company lacks a *legal obligation* to disclose an actual or potential violation, as is often the case, it still may be in its best interest to disclose the information. Many agencies, including the SEC, CFTC, and DOJ, have voluntary disclosure programs to encourage companies to provide such information in return for reduced penalties or non-prosecution agreements. But prosecution is by far *not* the government's only or most potent weapon. The collateral consequences of a prosecution action, such as suspension, debarment, and exclusion, often can be more harmful. Negative press associated with a formal enforcement investigation or prosecution may significantly affect the value of a company's publicly traded securities and lead to higher lending costs, strained shareholder relationships, and morale problems. A fact-specific analysis may need to be performed to assess, among other things, whether an event is so significant that it should be immediately disclosed in light of the history of events, the company's size, its overall profitability and the information already in the public realm.
