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Unfinished Business: Dodd-Frank's Whistleblower Anti-Retaliation Protections Fall Short for Private Companies and Their Employees

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UNFINISHED BUSINESS: DODD-FRANK'S WHISTLEBLOWER ANTI-RETRALIATION PROTECTIONS FALL SHORT FOR PRIVATE COMPANIES AND THEIR EMPLOYEES

CHELSEA HUNT OVERHULS*

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ABSTRACT

The Sarbanes-Oxley Act of 2002 (“SOX”) revolutionized the world of securities law whistleblowing. It encouraged employees to reveal corporate fraud by providing federal anti-retaliation protection to incentivize such reports. Securities law whistleblowing was transformed a second time in 2010 when Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). Under Dodd-Frank, employees that report information to the Securities and Exchange Commission (“SEC”) are not only provided federal anti-retaliation protections but also are eligible for a hefty bounty. Two major differences separate these statutes: (1) SOX is limited to employees of companies who are subject to the reporting requirements of the Exchange Act, but Dodd-Frank is not; and (2) SOX provides federal anti-retaliation protection for internal reporting, but Dodd-Frank does not. As a result, employees of companies that are not subject to the reporting requirements of the Exchange Act (“private employees”) are now faced with the choice to either (1) report internally, receive no federal anti-retaliation protection, and be ineligible for a federal bounty; or (2) to report to the SEC, receive federal anti-retaliation protection, and also become eligible for a federal bounty of at least ten percent of sanctions imposed. Thus, a well-informed whistleblower is left with no choice—he should bypass internal reporting procedures and report directly to the SEC. This Article examines the problems associated with this “private company loophole” in more detail. In particular, it argues that if Congress provides a federal bounty and federal anti-retaliation protection to private employee whistleblowers that report to the SEC, it should also provide federal anti-retaliation protection to private employee whistleblowers that report internally.

I. INTRODUCTION

Enron changed everything.¹ The fall of Enron destroyed the livelihoods of 20,000 employees and tainted the public’s trust in American corporations.² Immediately thereafter, Congress passed the Sarbanes-Oxley Act of 2002 (“SOX”),³ which afforded public⁴ company whistleblower employees anti-retaliation protection for reporting violations of federal securities laws.⁵ The hope

¹ *Enron: The Fraud that Changed Everything*, INDEP. (Apr. 09, 2006), <http://www.independent.co.uk/news/business/analysis-and-features/enron-the-fraud-that-changed-everything-473374.html>.

² *Id.*

³ Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C.A. § 1514A (West, Westlaw through P.L. 112-207).

⁴ When used in this Article, “public” refers to a corporation that is subject to the reporting requirements in the Securities and Exchange Act of 1934 (the “Exchange Act”) because the company is either required to register under section 12 of the Exchange Act or required to file reports under section 15(d) of the Exchange Act. *See generally* Securities Act of 1933, 15 U.S.C. § 78a–78mm (2006).

⁵ *Id.*

was that if honest employees were afforded federal anti-retaliation protections, they would be motivated to report corporate wrongdoing and prevent a disaster, such as Enron, from reoccurring.⁶ After the financial crisis of 2008, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), which expanded securities-related whistleblower protections in many ways.⁷ Even with the increased protections provided in these statutes, anti-retaliation protections fall short for private⁸ companies and their whistleblower⁹ employees. This Article examines the current state of the law and proposes a solution to the private company loophole created by these statutes.

Part II examines a whistleblower’s position in corporate governance. Part III describes a case that involves the private company loophole set forth in Part IV. Part IV explains the private company loophole. This loophole results from current federal law providing anti-retaliation protection to private company whistleblowers if they report to the Securities and Exchange Commission (the “SEC”), but not if they report internally.

Parts V through VII describe why the federal government should provide private company employees protection for internal reporting. Part V argues that such protection is warranted because private companies are already subject to the anti-fraud provisions of the federal securities laws and that the protection is necessary in light of the incentives Dodd-Frank gives private company whistleblowers to report to the SEC. Next, Part VI suggests that the current state of the law will confuse prospective private company whistleblowers and, in turn, will undermine Dodd-Frank’s goals. Additionally, Part VII argues that without internal reporting protection, the incentives Dodd-Frank gives well-informed private employees to report to the SEC will destroy private companies’ internal compliance systems.

Part VIII proposes a solution to the private company loophole created by Dodd-Frank. Most importantly, it urges Congress to adopt federal anti-retaliation protections for private company whistleblowers that report internally.

⁶ See generally S. REP NO. 107-146 (2002).

⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act § 922, 15 U.S.C.A. § 78u-6 (West, Westlaw through P.L. 112-207).

⁸ When used in this Article, “private” refers to a company that is neither required to register under section 12 of the Exchange Act nor is required to file reports under section 15(d) of the Exchange Act. See generally Securities Act of 1933 § 78a–78mm.

⁹ When used in this Article, “whistleblower” refers to an employee who informs the authorities concerning a federal securities law violation. There are whistleblower protections in many other areas—health, safety, etc.—that apply to both privately held and publicly held companies. See *The Whistleblower Protection Program*, U.S. DEPARTMENT OF LAB. (Mar. 03, 2012), <http://www.whistleblowers.gov/index.html> (stating the various whistleblower statutes enforced by the Occupational Safety and Health Administration (“OSHA”)). Due to the traditional public policy determination that public investors justify federal securities laws, protections for private company securities-related whistleblowers have not been as thoroughly addressed as in other whistleblower categories. Fredrick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535, 585 (2005). Unless otherwise indicated, this Article only addresses securities-related whistleblower protections, which is why there is a public-private dichotomy throughout it. See *infra* Part V.A. for more detail.

II. A WHISTLEBLOWER'S FUNCTION IN CORPORATE GOVERNANCE

A. Value-Add

Whistleblowers, as the corporation's conscience, are the essential element in revealing and preventing corporate fraud. "[T]he best way to fight financial fraud is to incentivize and protect whistleblowers."¹⁰ Understanding this truth is even more important in recent years as corporate securities fraud has become increasingly sophisticated.¹¹ According to the Fiscal Year 2011 Annual Report on the Dodd-Frank Whistleblower Program, market manipulation (16.2%), corporate disclosures and financial statements (15.3%), and offering fraud (15.6%) were the most commonly reported securities frauds in fiscal year 2011.¹²

The role whistleblowers play in preventing and detecting fraud is more than conceptual. A study conducted by Professor Alexander Dyck of the University of Toronto and two of his colleagues at the University of Chicago provides statistical evidence that employees are instrumental in revealing corporate fraud.¹³ Professor Dyck analyzed corporate frauds in large United States companies from 1996 to 2004. With a sample size of 216 Professor Dyck found that the SEC revealed 7% of frauds; auditors, 10%; industry regulators, 13%; equity holders, 3%; the media, 13%; and employees, with the largest percentage, 17%.¹⁴

The main reason whistleblower employees are important to revealing corporate securities fraud is because whistleblower employees have better institutional knowledge than external monitors, such as auditors.¹⁵ The majority of information that inside employees possess regarding a corporation is unavailable to the public or external monitors.¹⁶ Moreover, very few frauds could be committed

¹⁰ Jordan Thomas, a former SEC lawyer. Brooke Masters, *Enron's Fall Raised the Bar in Regulation*, FIN. TIMES (Dec. 1, 2011), <http://www.ft.com/cms/s/0/9790ea78-1aa9-11e1-ae14-00144feabdc0.html#axzz2AAAThdcD>.

¹¹ "'Enron changed everything,' said Jordan Thomas, a former [SEC] lawyer. 'Because of how challenging the Enron fraud was, how document-intensive and time consuming, it . . . led to far more sophisticated accounting fraud teams at the SEC. It raised the bar for law enforcement.'" Masters, *supra* note 10.

¹² U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM, 5 (2011), available at <http://www.sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf>.

¹³ I.J. Alexander Dyck, Adair Morse, & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213, 2213–14 (2010).

¹⁴ *Id.* at 2213–15. Other studies have found an even higher correlation between employee-whistleblowing and corporate fraud revelation. For example, in a 2007 study PricewaterhouseCoopers (PWC) found that internal controls were not enough to detect corporate fraud. Upon finding that 43% of corporate fraud was exposed by "whistleblowing related activities," PWC stated that encouraging whistleblowers to report wrongdoing is a necessity. STEPHEN M. KOHN, NAT'L WHISTLEBLOWERS CTR., WHY WHISTLEBLOWING WORKS AND WHAT CONGRESS MUST DO ABOUT IT, 2 (2007), available at <http://www.whistleblowers.org/storage/whistleblowers/documents/whistleblower%20conference%20policy%20paper%20final.pdf>.

¹⁵ Rachel Beller, *Whistleblower Protection Legislation of the East and the West: Can it Really Reduce Corporate Fraud and Improve Corporate Governance?*, 7 N.Y.U. J. L. & BUS. 873, 880 (2011); Dyck, Morse & Zingales, *supra* note 13, at 23.

¹⁶ Jisso Kim, *Confession of a Whistleblower: The Need to Reform the Whistleblower Provision of the Sarbanes-Oxley Act*, 43 J. MARSHALL L. REV. 241, 250 (2010); Dyck, Morse & Zingales, *supra* note 13, at 23.

without some employee participation.¹⁷

B. Anti-Retaliation Protections—Essential to Encourage Employees to Blow the Whistle

Given the fact that employee whistleblowers are the “single most important corporate resource for detecting and preventing fraud,”¹⁸ it is critical to encourage employees to blow the whistle. Not surprisingly, there are many disadvantages to whistleblowing.¹⁹ One of the primary reasons employees are reluctant to blow the whistle is the fear of employer retaliation.²⁰

1. Retaliation Examples

When Enron suddenly went into bankruptcy in 2001, it was an employee who disclosed the company’s massive accounting scandal.²¹ However, many of Enron’s employees knew of this accounting fraud well before Enron’s collapse.²² The primary reason the Enron employees did not reveal Enron’s corporate malfeasance sooner was because they did not want to lose their jobs.²³ If adequate whistleblower anti-retaliation laws had existed during this time period, the Enron employees that had knowledge of the company’s securities fraud would have been more likely to disclose and correct it before the fraud caused massive financial losses to Enron’s shareholders, employees, and other stakeholders associated with the company.²⁴

Anti-retaliation protection is even more important when you consider the *indirect* effects of blowing the whistle. David Welch, the first whistleblower to seek protection under the whistleblower provision of SOX,²⁵ told a discouraging story of his search for a new job five years after he blew the whistle on Cardinal Bancshares.²⁶ Welch, former Chief Financial Officer of Cardinal Bancshares, had to find a new job after he was denied anti-retaliation protection post-whistleblowing.²⁷ Welch stated that “when prospective employers began to check references, it was the end.”²⁸ “The bank told them I was a whistle-blower. Prospective employers assumed I [was] not to be trusted. I have a black eye in the accounting and banking industry . . . [i]t’s like there is a bull’s-eye painted on

¹⁷ Dyck, Morse & Zingales, *supra* note 13, at 23.

¹⁸ KOHN, *supra* note 14, at 1.

¹⁹ Beller, *supra* note 15, at 875.

²⁰ *Id.*

²¹ *Id.* at 876. “We learned from Sherron Watkins of Enron that these corporate insiders are the key witnesses that need to be encouraged to report fraud and help prove it in court. There was no way we could have known about this without that kind of a whistleblower.” 148 CONG. REC. 14, 447 (2002).

²² Beller, *supra* note 15, at 876.

²³ *Id.*

²⁴ *Id.*

²⁵ Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C.A § 1514A (West, Westlaw through P.L. 112-207).

²⁶ Kim, *supra* note 16, at 242.

²⁷ *Id.*

²⁸ *Id.*; Stephen Taub, *Five Years Out of Work*, CFO.COM (May 18, 2007), http://www.cfo.com/article.cfm/9210493/l/c_9211482.

you.”²⁹ After years of searching for a job, Welch switched careers and now teaches accounting at Franklin University in Ohio.³⁰ Many other whistleblowers have the same disappointing story.³¹

As a result of stories like David Welch, Congress included a whistleblower provision, section 922 of the Dodd-Frank Act, which was enacted on July 21, 2010.³² Section 922 of the Dodd-Frank Act—described in more detail below—established a whistleblower bounty program (the “Bounty Program”), which gives employee whistleblowers a significant monetary award (referred to as “bounties”) if they provide information to the SEC and that information meets certain criteria.³³ In addition, section 922 of the Dodd-Frank Act provides a new private right of action for whistleblowers who report information to the SEC and are subsequently retaliated against.³⁴ The Dodd-Frank private right of action expands whistleblower protections in a number of ways.³⁵ The hope is that the combination of increased whistleblower anti-retaliation protections with the Bounty Program will encourage employees to blow the whistle in the face of the disadvantages associated with whistleblowing.³⁶

2. Practical Retaliation Relief—Economic Reinstatement

While commentators have stated that both anti-retaliation protections and bounties are necessary to encourage employees to blow the whistle,³⁷ it is important to understand that the practical benefit of a successful anti-retaliation claim is the inclusion of a monetary award. The monetary award provided by the anti-retaliation claim is usually just enough to make the employee “whole” by providing compensation for the future years of income lost because the employee blew the whistle.³⁸ The bounty, on the other hand, is an award based on the dollar amount of SEC sanctions imposed on the whistleblower’s company as a result of

²⁹ *Id.*

³⁰ Kim, *supra* note 16, at 242.

³¹ *Id.* A former Xerox whistleblower’s lawyer stated that his client, James Bingham, “had a great career but he’ll never get a job in Corporate America again.” Dyck, Morse & Zingales, *supra* note 13, at 23.

³² Dodd-Frank Wall Street Reform and Consumer Protection Act § 922, 15 U.S.C.A. § 78u-6 (West, Westlaw through P.L. 112-207).

³³ Beller, *supra* note 15, at 914–15; 15 U.S.C.A. § 78u-6(a) (West 2012). The amount of the bounty is significant, anywhere from ten to thirty percent of monetary sanctions in excess of one million dollars. 15 U.S.C.A. § 78u-6(a)–(b) (West 2012).

³⁴ Beller, *supra* note 15, at 914; 15 U.S.C.A. § 78u-6(a) (West 2012).

³⁵ Beller, *supra* note 15, at 914; *see infra* Part IV.

³⁶ *Significant Number of Americans have Knowledge of Workplace Misconduct and are Willing to Blow the Whistle, According to Labaton Sucharow Survey*, LABATON SUCHAROW (Dec. 11, 2011), <http://www.labaton.com/en/about/press/Labaton-Sucharow-announced-the-results-of-its-nationwide-Ethics-and-Action-Survey.cfm> (stating that a recent survey shows that thirty four percent of respondent employees knew of wrongdoing in the workplace and seventy eight percent of “respondents indicated they would report wrongdoing in the workplace if it could be done anonymously, without retaliation and result in a monetary award.”).

³⁷ *Id.*

³⁸ Beller, *supra* note 15, at 876; Laurence S. Moy, et al., *Whistleblower Claims Under the Sarbanes-Oxley Act of 2002*, 1912 PLLI/CORP 731, 793 (2011).

the information the whistleblower provided.³⁹

David Welch of Cardinal Bancshares was denied anti-retaliation protection under SOX.⁴⁰ However, even if he had been successful, he would likely not have actually been reinstated as Cardinal Bancshare's Chief Financial Officer. Rather, it is more likely he would have been awarded an economic reinstatement.⁴¹ Under SOX, the economic reinstatement typically means that the employer will be "required to pay the employee the same compensation and benefits he received prior to termination," even though the employee would not return to work.⁴²

The typical rationale for the economic equivalent of reinstatement as opposed to actual reinstatement is that whistleblowing creates a hostile environment for employees post-whistleblowing—especially for executives.⁴³ Even though there has not yet been a case under Dodd-Frank addressing this economic equivalent of reinstatement issue,⁴⁴ cases under Dodd-Frank will likely follow a similar path. Therefore, the reinstatement laws this Article discusses are not typically valuable because the employee is actually reinstated. However, the reinstatement laws are extremely valuable in that they can provide the employee with the economic equivalent of reinstatement.

III. HONESTY WAS NOT THE BEST POLICY: INTERNAL REPORTING PROHIBITED ANTI-RETALIATION CLAIM—*EGAN V. TRADINGSCREEN, INC.*

While Dodd-Frank, as discussed in Parts IV and V, below, clearly expands whistleblower anti-retaliation protections, it also fails to provide anti-retaliation protection to employees of privately held companies that report internally.⁴⁵ Patrick Egan experienced this omission firsthand. Mr. Egan was employed by TradingScreen, Inc. ("TradingScreen"), a privately held financial software business, from 2003 until his termination in 2010.⁴⁶ In 2007, Mr. Egan was

³⁹ 15 U.S.C.A. § 78u-6 (West 2012).

⁴⁰ Under SOX, there is a rather detailed process that a whistleblower must follow when filing for anti-retaliation protection with the Department of Labor. First, the employee whistleblower must file with OSHA. See generally, Robert B. Fitzpatrick, *American Bar Association of Labor and Employment Federal Labor Standards Legislation Committee 2011 Midwinter Meeting Report: Subcommittee on the Sarbanes-Oxley Act of 2002*, SS032 ALI-ABA 201 (2011). OSHA's decision can then be reviewed by an Administrative Law Judge ("ALJ"). *Id.* Finally, the ALJ's decision may be reviewed by the Administrative Review Board ("ARB"). *Id.* It was the ARB that denied Welch's claim for reinstatement. *Id.* at 285. See *infra* Part IV.A.

⁴¹ See Steven F. Cherry & Thomas W. White, *Sarbanes-Oxley Whistleblower Wins Reinstatement and Monetary Damages*, WILMERHALE (March 1, 2005), <http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=216> (stating that "courts are generally more likely in employment retaliation cases to award the economic equivalent of reinstatement, rather than actual reinstatement."). Note this article was actually referring to David Welch, because he was successful at the ALJ level. However, his success would soon be defeated by the ARB's ruling. Fitzpatrick, *supra* note 40, at 285.

⁴² Moy, *supra* note 38, at 793.

⁴³ See Cherry & White, *supra* note 41.

⁴⁴ Search Results on Westlaw and LexisNexis of all federal cases for "whistleblower & reinstatement & dodd-frank" revealed no cases on the topic.

⁴⁵ Joan E. McKown, Michael Dailey & Bart Green, *The SEC's Whistleblower Program and Its Effects on Hedge Funds*, 1919 PLI/CORP 193, 197 (2011).

⁴⁶ *Egan v. TradingScreen, Inc.*, No. 10. Civ. 8202(LBS), 2011 WL 1672066, at *1-2 (S.D.N.Y. May 4, 2011).

promoted to the “Head of Sales for the Americas.”⁴⁷ In early 2009, Mr. Egan discovered that Philippe Buhannic, Chief Executive Officer of TradingScreen, “was diverting TradingScreen’s corporate assets to another company that he solely owned, SpreadZero, which offered products and services similar to those of TradingScreen.”⁴⁸ Among other things, Mr. Egan alleged that Mr. Buhannic was having TradingScreen employees do unpaid work for SpreadZero and that he was stealing TradingScreen’s customers.⁴⁹ By late 2009, Mr. Egan concluded that Mr. Buhannic’s actions were “posing a threat to the existence of TradingScreen’s business.”⁵⁰

In January 2010, Mr. Egan reported Mr. Buhannic’s actions to Michael Chin, the President of TradingScreen.⁵¹ Mr. Chin subsequently passed this information to TradingScreen’s independent directors—those not controlled by Mr. Buhannic.⁵² The independent directors had Latham Watkins LLP (“Latham”) conduct an internal investigation regarding Mr. Egan’s allegations.⁵³ In March 2010, Latham confirmed Mr. Egan’s allegations.⁵⁴

On March 12, 2010, the independent directors told Mr. Buhannic that he would be forced to resign.⁵⁵ However, on March 15, 2010, Mr. Buhannic gained control of the independent directors.⁵⁶ Rather than Mr. Buhannic announcing his resignation as originally anticipated, on June 2, 2010 he fired both Mr. Egan and Mr. Chin.⁵⁷ Soon thereafter Mr. Egan filed a complaint that asserted, among other things, that he was entitled anti-retaliation protection under Dodd-Frank.⁵⁸

When analyzing Mr. Egan’s anti-retaliation claims, the Court noted that Dodd-Frank protects whistleblowers that report information *to the SEC*.⁵⁹ Additionally, it noted that Dodd-Frank protects employees that do not report the information to the SEC in other limited circumstances.⁶⁰ Of these other limited circumstances, the most common occurs when an employee whistleblower makes “disclosures that are required or protected under [SOX].”⁶¹ However, the Court stated that “the whistleblower provisions of [SOX] section 806 apply only to publicly traded companies with securities registered under section 12 of the Securities and Exchange Act of 1934 . . . or public companies required to file reports under section 15(d) of the Exchange Act”⁶²

⁴⁷ *Id.* at *1.

⁴⁸ *Id.* at *2.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.* at *3; Dodd-Frank Wall Street Reform and Consumer Protection Act § 922, 15 U.S.C.A. § 78u-6(h)(1)(C) (West, Westlaw through P.L. 112-207).

⁵⁹ *Egan*, 2011 WL 1672066, at *3; 15 U.S.C.A. § 78u-6(h)(1)(A)(i)–(ii) (West 2012).

⁶⁰ *Egan*, 2011 WL 1672066, at *4–5.

⁶¹ *Id.*; 15 U.S.C.A. § 78u-6(h)(1)(A)(iii) (West 2012).

⁶² *Egan*, 2011 WL 1672066, at *5; Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C.A. § 1514A

The Court also stated that “[t]he legislative history of the Act provides little evidence of Congress’s purpose. . . . [A]nd [it] contain[s] very few substantive discussions of its anti-retaliation provisions. Of those few, none touch upon the issue of whether reporting to the SEC is required for whistleblowers to avail themselves of the Act’s anti-retaliation provisions.”⁶³ Ultimately, the Court held that while Dodd-Frank would have protected Mr. Egan from TradingScreen’s retaliation if he had reported the information to the SEC, the protection was unavailable to him in this instance because he only reported Mr. Buhannic’s actions internally.⁶⁴

In addition to the holding above, the Court stated that “reporting” should be construed broadly. Thus, the Court said that Mr. Egan could possibly qualify for protections under Dodd-Frank if he could prove that: “(1) he initiated the inquiry into the violation; and (2) the information that he disclosed to [Latham] was *actually* reported to the SEC.”⁶⁵ If Mr. Egan could prove these two elements, then it could be said that he “jointly” reported the information to the SEC and he would be afforded the anti-retaliation protections under Dodd-Frank.⁶⁶ While the Court granted Mr. Egan relief to amend his complaint to plead facts that show the information was transmitted to the SEC, the *TradingScreen II* court held that Mr. Egan failed to show that the SEC actually received the information. Thus, Mr. Egan was not granted anti-retaliation protection under Dodd-Frank.⁶⁷

The detailed facts and holding of *TradingScreen* set out above are troubling to both private companies and their prospective whistleblower employees. If Congress has provided protection to employee whistleblowers of privately held companies when they report securities laws violations to the SEC, surely it should also provide protection if the same employee reports the identical information internally. The remainder of this paper will set forth and analyze in detail the Dodd-Frank whistleblower provisions. However this issue of internal reporting protection for private company employees has never been addressed. Congress must address this issue in order for private company employees to believe that honesty is still the best policy.

(West, Westlaw through P.L. 112-207).

⁶³ *Egan*, 2011 WL 1672066, at *4.

⁶⁴ *Id.* at *5; McKown, Dailey & Green, *supra* note 45, at 198–99.

⁶⁵ McKown, Dailey & Green, *supra* note 45, at 198–99; *Egan*, 2011 WL 1672066 at, *7–9.

⁶⁶ *Id.*; *see also* 15 U.S.C.A. § 78u-6(a)(6) (West 2012).

⁶⁷ *Egan v. TradingScreen, Inc.*, No. 10 Civ. 8202(LBS), 2011 WL 4344067, at *3–4 (“*TradingScreen II*”).

IV. PRIVATE COMPANY INTERNAL REPORTING LOOPHOLE: BACKGROUND ON
FEDERAL ANTI-RETALIATION PROTECTIONS⁶⁸

A. *Whistleblower Laws Pre-Dodd-Frank*

Prior to the enactment of Dodd-Frank in 2010, the most significant expansion of securities-related whistleblower anti-retaliation protections occurred after scandals in 2001, such as Enron,⁶⁹ when Congress passed SOX in 2002. SOX's whistleblower protection provisions set forth in section 806 provided anti-retaliation protection to employees of publicly traded companies⁷⁰ that blew the whistle.⁷¹ At that time, a SOX public company was defined as a company with a class of securities registered under section 12 of the Exchange Act or a company that is required to file reports under section 15(d) of the Exchange Act.⁷² Currently, section 806 forbids public companies from retaliating⁷³ against an employee who reports securities law violations to a federal regulatory or law enforcement agency, any member or committee of Congress, or a person with supervisory authority over the employee (i.e. internal reporting).⁷⁴ An employee is protected under section 806, even if he was incorrect about the corporate malfeasance, if he had a "reasonable belief" that corporate wrongdoing occurred.⁷⁵

While the protection SOX affords public company whistleblower employees appears to be great, two other provisions significantly limit the protections. First, the employee has a very limited time period in which to file a claim. Under pre-Dodd-Frank SOX, an employee had to file a complaint alleging retaliation with the Department of Labor ("DOL") *within ninety days* of the retaliatory act.⁷⁶ After filing a complaint, the Occupational Safety and Health Administration ("OSHA") (an agency of the DOL), not a federal district court, will review the whistleblower's complaint.⁷⁷ This is problematic for a couple of reasons. First, under this system there are many levels of review, which can draw the litigation out.⁷⁸ OSHA's decision can be appealed to an Administrative Law Judge ("ALJ").⁷⁹ The ALJ's decision can be appealed to the Administrative Review

⁶⁸ It is important to note that there are state whistleblower protections, but state laws do not provide sufficient anti-retaliation protection for private company employees who report internally. See Part VII.B, below.

⁶⁹ Beller, *supra* note 15, at 903; Dan Ackman, *Sherron Watkins Had Whistle, but Blew It*, FORBES (Feb. 14, 2002, 3:50 PM), <http://www.forbes.com/2002/02/14/0214watkins.html>.

⁷⁰ Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C.A. § 1514A (West, Westlaw through P.L. 112-207).

⁷¹ Beller, *supra* note 15, at 904; 18 U.S.C.A. § 1514A (West 2012).

⁷² 18 U.S.C.A. § 1514A(a) (West 2012).

⁷³ Retaliation means "any discharge, demotion, suspension, threat, harassment, or any other discrimination against an employee in the terms and conditions of employment because of any lawful act done by the employee." *Id.*

⁷⁴ 18 U.S.C.A. § 1514A(a)(1) (West 2012).

⁷⁵ *Id.*; Beller, *supra* note 15, at 906.

⁷⁶ 18 U.S.C.A. § 1514A(b)(2)(D) (West 2012); Beller, *supra* note 15, at 904. Dodd-Frank extended this time period. See Part IV.B.

⁷⁷ 18 U.S.C.A. § 1514A(b) (Westlaw); Beller, *supra* note 15, at 904-05.

⁷⁸ Kim, *supra* note 16, at 253; see generally Fitzpatrick, *supra* note 40.

⁷⁹ See generally Fitzpatrick, *supra* note 40.

Board (“ARB”).⁸⁰ Finally, the ARB’s decision can be appealed to the United States Court of Appeals in the circuit “where the alleged violation occurred.”⁸¹ Second, it is problematic because OSHA is inexperienced in dealing with security law claims.⁸² Still, it was clear even before Dodd-Frank that publicly traded company employees were afforded at least some protection under SOX if they thought it was necessary to blow the whistle.

B. Dodd-Frank

1. Enhanced Protections in Section 806 of SOX

Dodd-Frank revised section 806 of SOX to expand whistleblower protections in two important ways. First, it increased the time in which a whistleblower could file a complaint from ninety days to one hundred eighty days.⁸³ Additionally, it amended section 806 of SOX to protect employees of any subsidiary or affiliate of a public company whose financial information is included in the consolidated financial statements of such company, or in a nationally recognized statistical rating organization.⁸⁴ These two provisions significantly expanded whistleblower anti-retaliation protections under SOX.

2. Report to SEC—Public and Private Company Employees Protected

In addition to the added protections under section 806 of SOX, Dodd-Frank creates a new private right of action to help whistleblowers combat retaliation.⁸⁵ In contrast to section 806 of SOX, under the new Dodd-Frank private right of action, an employee whistleblower can bypass the DOL and file an anti-retaliation complaint directly in the proper federal district court.⁸⁶ Further, the Dodd-Frank private right of action gives whistleblowers a very generous statute of limitations.⁸⁷ Specifically, section 922(h)(1)(B)(iii) states that a claim under this section cannot be brought more than six years after the date on which the qualified discrimination occurred or more than three years after the date when facts material to the qualified discrimination are known or reasonably should have been known by the employee.⁸⁸ Expanding the window of time for whistleblowers will reduce the chances that they will be retaliated against simply because they do not immediately file a complaint.

⁸⁰ *Id.*

⁸¹ *Id.* at 263. This is somewhat mitigated by the fact that an employee can file for de novo review in a federal district court if the DOL has not issued a final decision within 180 days. However, this process is still time-consuming and confusing. See Kim, *supra* note 16, at 253.

⁸² Kim, *supra* note 16, at 253. These are just two of the many reasons that it is problematic for employees to file with the DOL. For more details, see Kim, *supra* note 16, at 251–53.

⁸³ Beller, *supra* note 15, at 914; Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C.A. § 1057 (West, Westlaw through P.L. 112-207); Sarbanes-Oxley Act of 2002, 18 U.S.C.A. § 1514A(b)(2)(D) (West, Westlaw through P.L. 112-207).

⁸⁴ 18 U.S.C.A. § 1514A(a) (West 2012).

⁸⁵ 15 U.S.C.A. § 78u-6(h) (West 2012).

⁸⁶ *Id.*; Beller, *supra* note 15, at 914.

⁸⁷ 15 U.S.C.A. § 78u-6(h)(1)(B)(iii) (West 2012).

⁸⁸ *Id.*

A whistleblower is eligible for anti-retaliation protections afforded under section 922 of Dodd-Frank if he: (1) possesses a reasonable belief⁸⁹ that the information he is providing relates to a possible securities law violation that has occurred, is ongoing, or is about to occur⁹⁰ and (2) provides that information in a manner described in section 21F(h)(1)(A) of the Exchange Act.⁹¹ Section 21F(h)(1)(A) states that:

No employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower (i) in providing information *to the Commission* in accordance with this section [or] (ii) in initiating, testifying in, or assisting in any investigation or judicial or administrative⁹² action *of the Commission* based upon or related to such information.

According to section 21F(h)(1)(A)(i) and (ii), the new private right of action applies to whistleblower employees of both public and privately held companies as long as the employee reports the suspected malfeasance *to the SEC*.⁹³

The *TradingScreen* court acknowledged this new private right of action for private company employees when it stated that Mr. Egan would have been protected under Dodd-Frank if he had reported Mr. Buchannic's actions *to the SEC*.⁹⁴ It is clear from the plain statutory language of section 922 of Dodd-Frank that an employee of a privately held company can bring an anti-retaliation claim under section 922 of Dodd-Frank if that employee reports his knowledge of corporate malfeasance *to the SEC*.

3. Internal Reports—Private Company Employees Unprotected⁹⁵

Even though Dodd-Frank clearly provides a private right of action to a

⁸⁹ Proclamation No. 113, 76 Fed. Reg. 34303 (June 13, 2011).

The “reasonable belief” standard requires that the employee hold a subjectively genuine belief that the information demonstrates a possible violation, *and* that this belief is one that a similarly situated employee might reasonably possess. We believe that requiring a “reasonable belief” on the part of a whistleblower seeking anti-retaliation protection strikes the appropriate balance between encouraging individuals to provide us with high-quality tips without fear of retaliation, on the one hand, while not encouraging bad faith or frivolous reports, or permitting abuse of the anti-retaliation protections, on the other.

Id.

⁹⁰ Note that this definition provides whistleblowers eligible for protection under Dodd-Frank broader protections for reporting than under SOX section 806. This is because the reasonable belief does not have to be about a violation that has occurred. Rather, it could also be a reasonable belief about a possible violation that is ongoing or is about to occur.

⁹¹ 15 U.S.C.A. § 78u-6(h)(1)(A) (West 2012). Also, it is important to note that the anti-retaliation protections apply whether or not the whistleblower qualifies for the Bounty Program. Securities Whistleblower Incentives and Protections, 17 C.F.R. § 240.21F-2(b)(1)(ii) (2011).

⁹² 15 U.S.C.A. § 78u-6(h) (West 2012) (emphasis added).

⁹³ *Id.*

⁹⁴ Egan v. TradingScreen, Inc., No. 10. Civ. 8202(LBS), 2011 WL 1672066, at *3 (S.D.N.Y. May 4, 2011).

⁹⁵ It is also important to note that the SEC, in addition to the individual whistleblower, can bring a federal anti-retaliation action under section 922 of Dodd-Frank. 17 C.F.R. § 240.21F-2(b)(2).

private company whistleblower who reports corporate wrongdoing *to the SEC*, it is silent on anti-retaliation protections for private company whistleblowers that report internally. As discussed above, in order to be afforded federal anti-retaliation protection under Dodd-Frank, an employee must provide information in a manner described in 21F(h)(1)(A) of the Exchange Act. Subsection (i) and (ii) of this section are set forth in Part IV.B.2., above.

Section 21F(h)(1)(A)(iii), the final “manner” described in that section, states:

No employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower . . . (iii) in making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), including section 10A(m) of such Act (15 U.S.C. 78f(m)), section 1513(e) of title 18, United States Code,⁹⁶ and any other law, rule, or regulation subject to the jurisdiction of the Commission.

While the last two methods stated in 21F(h)(1)(A)(iii) could potentially afford a private company employee with standing to bring a federal anti-retaliation claim against his employer, those situations are limited.⁹⁷ The other methods generally only provide anti-retaliation protection to public company employees.⁹⁸ In fact, Dodd-Frank does not explicitly provide anti-retaliation protection for internal reporting at all.⁹⁹ Rather, internal reporting anti-retaliation protection is derived from the language in section 922 that references SOX.¹⁰⁰ As stated in Part IV.A. above, section 806 of SOX prohibits public companies from retaliating against an employee who reports corporate wrongdoing to a person with supervisory authority over the employee (i.e. internal reporting).¹⁰¹

The Practicing Law Institute (the “PLI”) recognized this internal reporting problem when it was analyzing Dodd-Frank’s impact on hedge funds.¹⁰² More specifically, the PLI noted in a November 2011 article that the “SEC has not yet provided protections to employees of *private* companies, including hedge funds, against retaliation for internally reporting. The anti-retaliation provisions under Dodd-Frank for *internal* reporting apply only to employees of public companies.”¹⁰³ The Federal Register also noted the absence of internal reporting

⁹⁶ 17 C.F.R. § 240.21F(h)(1)(A)(iii).

⁹⁷ See generally Egan, 2011 WL 1672066.

⁹⁸ See Howard E. Berkenblit & Stacy H. Louizos, *SEC’s Whistleblower Program Finalized*, BUSINESS LAW TODAY (July 14, 2011), <http://apps.americanbar.org/buslaw/blt/content/2011/07/keep-ingcurrent-securities2.shtml> (stating that “whistleblowers who make disclosures that are required or protected under the Sarbanes-Oxley Act, Securities Exchange Act, or any other law subject to the jurisdiction of the SEC will generally only be protected if their tips pertain to public companies.”).

⁹⁹ Tammy Marzigliano & Jordan A. Thomas, *Advocacy and Counsel for the SEC Whistleblower*, BNA DAILY LABOR REPORT (Oct. 11, 2011), <http://knowledgenetwork.labaton.com/Advocacy-and-Counsel.cfm> (stating that “[i]t is critically important that employee advocates understand that despite the financial incentives offered by the SEC, internal reporting does not entitle an individual to the anti-retaliation protections of Dodd-Frank.”).

¹⁰⁰ Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C.A. § 1514A(a)(1) (West, Westlaw through P.L. 112-207).

¹⁰¹ *Id.*

¹⁰² McKown, Dailey & Green, *supra* note 45.

¹⁰³ *Id.* at 197.

protection for private company whistleblowers.¹⁰⁴

There is some room for interpretation in this new private right of action, as demonstrated in *TradingScreen*.¹⁰⁵ If an employee can prove that he has acted “jointly” with another individual who reported the alleged violations to the SEC (or his company subsequently reported such information), then he might also be eligible for protection under section 922.¹⁰⁶ However, as demonstrated in *TradingScreen*, this is hard to prove in practice. In sum, while Dodd-Frank clearly provides private company whistleblowers with anti-retaliation protection when they report corporate wrongdoing to the SEC, it is equally obvious that the same employees are not provided anti-retaliation protection when they report identical information internally.

V. SO WHAT’S THE BIG DEAL? OUR JOB IS TO PROTECT THE PUBLIC

Given the traditional public policy determination that public investors justify federal securities laws, a push for greater anti-retaliation protection for private company whistleblowers may seem unusual.¹⁰⁷ However, in light of the fact that (1) anti-fraud provisions apply to publicly and *privately* traded companies, (2) Dodd-Frank allows private company whistleblowers to be eligible for a bounty under the Bounty Program, and (3) Dodd-Frank provides anti-retaliation protection to private company whistleblowers that report to the SEC, it makes no sense not to protect private company employees from anti-retaliation for internally reporting.

A. Current Anti-Fraud Provisions

As stated above, Dodd-Frank does not address internal reporting at all. Rather, it refers to the internal reporting protections SOX provides. However, those protections only apply to public company employees. In contrast, many other federal whistleblower laws provide different types of whistleblowers (i.e. health and safety whistleblowers) with anti-retaliation protection, whether they work at a *private* or *public* company.¹⁰⁸ SOX’s whistleblower protections probably omit private company whistleblowers because of the traditional public policy determination that public investors justify securities laws.¹⁰⁹

¹⁰⁴ Proclamation No. 113, 76 Fed. Reg. 34304 (June 13, 2011). The Federal Register noted this limitation when it stated “the retaliation protections for internal reporting afforded by Section 21F(h)(1)(A) do not broadly apply to employees of entities other than public companies.” *Id.*

¹⁰⁵ *Egan v. TradingScreen, Inc.*, No. 10. Civ. 8202(LBS), 2011 WL 1672066 (S.D.N.Y. May 4, 2011); see also McKown, Dailey & Green, *supra* note 45, at 198 (stating “[t]he court reasoned that the employee could potentially qualify as a whistleblower under Dodd-Frank if he could show that: (1) he initiated the inquiry into the violation; and (2) the information that he disclosed to outside counsel was *actually* reported to the SEC.”).

¹⁰⁶ *Egan*, 2011 WL 1672066, at *7–9; see also McKown, Dailey & Green, *supra* note 45, at 198 and Dodd-Frank Wall Street Reform and Consumer Protection Act, § 922, 15 U.S.C.A. § 78u-6(a)(6) (West, Westlaw through P.L. 112-207) and Securities Whistleblower Incentives and Protections, 17 C.F.R. 240.21F-2(a) (2011).

¹⁰⁷ Dave Ebersole, *Blowing the Whistle on the Dodd-Frank Whistleblower Provisions*, 6 OHIO ST. ENTREPREN. BUS. L.J. 123, 144 (2011).

¹⁰⁸ See *The Whistleblower Protection Program*, *supra* note 9 and accompanying text.

¹⁰⁹ Gedicks, *supra* note 9, at 585.

However, private companies are also subject to numerous securities laws.¹¹⁰ In fact, anti-fraud provisions of the federal securities laws apply to private as well as public companies.¹¹¹ The SEC, in an enforcement action taken against Stiefel Labs on December 12, 2011, reiterated this reality.¹¹² In that case the SEC stated that “the anti-fraud provisions of the federal securities laws apply to all securities transactions—whether the securities in question are issued by a public or private company.”¹¹³ Even without considering the incentives Dodd-Frank creates through the Bounty Program and federal anti-retaliation protections, described in Part V.B. and C., below, it would make sense to extend federal anti-retaliation protection to private company employees that report internally simply because private companies are already subject to the anti-fraud provisions of federal securities laws.

B. Bounty Program

As stated above, Dodd-Frank created a new Bounty Program that requires the SEC to pay bounties to individuals who voluntarily provide original information *to the SEC* when that information meets certain criteria.¹¹⁴ Most importantly, the whistleblower is eligible for a bounty if the original information he voluntarily discloses to the SEC leads to monetary sanctions of at least one million dollars.¹¹⁵ While the SEC has discretion to determine the amount of the bounty, it must be at least ten percent and cannot be more than thirty percent of the monetary sanctions collected.¹¹⁶

Compliance with internal reporting procedures is a factor the SEC will use to help determine the amount of the bounty.¹¹⁷ Under the final SEC rules regarding Dodd-Frank’s whistleblower provision (“Final Rules”), a whistleblower’s participation in internal compliance systems is a factor that can increase the amount of the bounty.¹¹⁸ Alternatively, interference with internal compliance and

¹¹⁰ See generally Securities Act of 1933, 15 U.S.C. § 77a–77aa (2006).

¹¹¹ James D. Cox & Thomas Lee Hazen, 2 TREATISE ON THE LAW OF CORPORATIONS §12.9 (3d. ed. 2011) (stating that 10b-5’s “breadth is great as it applies to *any* security, regardless of whether the security is subject to the [Exchange] Act’s registration and reporting requirements.”).

¹¹² See Erika L. Robinson, et al., *SEC Reaffirms the Broad Reach of Rule 10b-5 to Private Companies*, WILMERHALE (Dec. 22, 2011), <http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=9999>.

¹¹³ See *id.*; see also Cox & Hazen, *supra* note 111 and accompanying text.

¹¹⁴ Securities Whistleblower Incentives and Protections, 17 C.F.R. § 240.21F-2(a)(2) (2011). For more details regarding criteria see 17 C.F.R. § 240.21F-3 (stating that as limited by the requirements of §§ 240.21F-2, 240.21F-8, and 240.21F-16, the Commission pays awards to whistleblowers that: “(1) Voluntarily provide the Commission (2) With original information (3) That leads to the successful enforcement by the Commission of a Federal court or administrative action (4) In which the Commission obtains monetary sanctions totaling more than \$1,000,000.”).

¹¹⁵ 17 C.F.R. § 240.21F-3; Dodd-Frank Wall Street Reform and Consumer Protection Act, § 922, 15 U.S.C.A. § 78u-6(a) (West, Westlaw through P.L. 112-207). Note that under the Final Rules, “the SEC will aggregate two or more smaller actions that arise from a set of common facts in order to meet the \$1,000,000 threshold for an award.” 17 C.F.R. § 240.21F-4(d)(1).

¹¹⁶ 17 C.F.R. § 240.21F-5; 15 U.S.C.A. § 78u-6(b) (West 2012).

¹¹⁷ 17 C.F.R. § 240.21F-6(a)–(b).

¹¹⁸ 17 C.F.R. § 240.21F-6(a)(4).

reporting systems is a factor that can decrease the amount of the bounty.¹¹⁹ However, participation or interference with internal compliance systems are just two factors, among many, that the SEC uses to determine the amount of the bounty.¹²⁰

The type of employee eligible for an award is another important criteria to examine. Unlike section 806 of SOX, Dodd-Frank does not limit the Bounty Program to public company employees.¹²¹ It follows that the Bounty Program applies to both public and private companies.¹²² Therefore, while private company employees are not afforded federal anti-retaliation protection for internally reporting, they are eligible to receive a hefty bounty if they report the information to the SEC.

C. Anti-Retaliation Protection

Although discussed in detail above, it is important to reiterate the fact that private company whistleblowers are only likely to receive federal anti-retaliation protection, in the form of economic reinstatement, if they report *to the SEC*.¹²³ There are currently few incentives for a private company whistleblower to comply with internal reporting procedures before going to the SEC.¹²⁴ In fact, the PLI stated:

Employees, even at companies where official policy compels that wrongdoing be reported and investigated, may downplay internal reports of wrongdoing . . . in order to avoid possible retaliation. At the very extreme, the current state of the case law and statutory language strongly suggest [that a private company whistleblower] may bypass internal compliance and report directly to the SEC in order to save his or her job.¹²⁵

In sum, the current state of the law almost obligates a well-informed private company employee who wants federal anti-retaliation protection to bypass internal reporting procedures and report violations directly to the SEC.

¹¹⁹ 17 C.F.R. § 240.21F-6(b)(3).

¹²⁰ 17 C.F.R. § 240.21F-6(a)-(b).

¹²¹ Sarbanes-Oxley Act of 2002, § 806, 18 U.S.C.A. § 1514A (West, Westlaw through P.L. 112-207); 15 U.S.C.A. § 78u-6 (West 2012).

¹²² See generally McKown, Dailey & Green, *supra* note 45; 15 U.S.C.A. § 78u-6(a) (West 2012); 17 C.F.R. § 240.21F-2(a) (in defining whistleblower, nowhere does it say that they have to be a public employee like SOX section 806 does). See also Lucienne M. Hartmann, *Whistle While Your Work: The Fairytale-Like Whistleblower Provision of the Dodd-Frank Act and the Emergence of "Greedy," the Eighth Dwarf*, 62 MERCER L REV. 1279, 1288 (stating that "[i]n general, the Dodd-Frank Act states that a whistleblower who provides 'original information' of a fraudulent act by a *public or privately held company* leading to a monetary sanction of at least \$1 million will be rewarded 10%–30% of the monetary sanction.") (emphasis added).

¹²³ See Part IV.B.

¹²⁴ McKown, Dailey & Green, *supra* note 45, at 199.

¹²⁵ *Id.*

VI. SPAGHETTI BOWL OF LAWS CREATES UNCERTAINTY AND UNREALIZED EXPECTATIONS

The private company whistleblower framework described above is a mess. Before blowing the whistle, a prospective private company whistleblower must decide if he wants to comply with his company's internal reporting procedures or not. As demonstrated in *TradingScreen*, if he does comply with internal reporting procedures without also reporting to the SEC, he risks possible retaliation without federal anti-retaliation protection. However, if he goes straight to the SEC, he can be sure that he will be afforded federal anti-retaliation protection.

A prospective whistleblower must also consider internal reporting in regards to the size of a possible bounty. Under the Final Rules, the SEC will consider compliance with internal reporting as a factor to increase or decrease an award. However, as demonstrated by David Welch's story, a well-informed whistleblower will likely choose a smaller bounty if it means that he will also receive federal anti-retaliation protection (i.e., economic reinstatement). If he reports directly to the SEC, a prospective whistleblower will receive a monetary reinstatement award as well as a minimum of ten percent of sanctions the SEC imposed even if he does not report internally before reporting to the SEC. Therefore, under the current state of the law, a well-informed private company employee is encouraged to bypass internal compliance procedures and report directly to the SEC.

What about an employee who is not well-informed? It seems there are at least two adverse outcomes that could result. First, an employee who cannot afford an attorney might decide that the effort he must put into understanding the laws outweighs any benefits he might gain from blowing the whistle. Even if he does have the money to seek advice, he might decide the cost of an attorney's advice outweighs the benefits gained from blowing the whistle. Clearly providing federal anti-retaliation protection to private company employees who report internally could decrease the information costs associated with this decision. Alternatively, unclear and inconsistent protections, as the current law provides, could lead to fewer whistleblower reports and thus dilute Dodd-Frank's purpose in regards to private company employees.

Even worse, a prospective whistleblower who is not well informed might blow the whistle internally under the impression that he will receive federal anti-retaliation protection. This is a plausible expectation given the fact that the SEC has stated the amount of the bounty will increase if a whistleblower first reports internally. If such an employee internally blows the whistle and is fired before he informs the SEC, similar to Mr. Egan in *TradingScreen*, he might lose his job without any protection at all.¹²⁶ Stories like this might, in turn, discourage other employees from reporting internally, thus, leading to the breakdown of private companies' internal compliance systems.

¹²⁶ Some states provide protections, see Part VII.B., below—but state laws are inconsistent and usually do not provide protection for internal reporting.

VII. PROBLEM FOR PRIVATE EMPLOYERS

A. *Internal Compliance Threatened*

As described above, well-informed employees of privately held companies have great incentives to bypass internal reporting procedures and report violations directly to the SEC. This is because if a private company whistleblower goes straight to the SEC, he is not only afforded federal anti-retaliation protection that is not available to him if he only reports internally, but he is also eligible for a hefty bounty. This problem does not exist to the same extent for prospective public company whistleblowers because section 806 of SOX provides at least some anti-retaliation protection for internally reporting. There does not seem to be a good reason for this distinction. By practically mandating well-informed private company employees to bypass internal reporting procedures and report directly to the SEC, the internal reporting loophole could completely destroy the purpose and effectiveness of private company internal compliance programs.¹²⁷

The internal reporting incentives in the Final Rules will probably not be enough to incentivize a well-informed prospective private company whistleblower to report internally because he might be fired before he reports the information to the SEC, and he is already guaranteed ten percent of the SEC sanctions anyway. To make existing internal reporting incentives have an effect on prospective private company whistleblowers decisions and to prevent the breakdown of private companies' internal compliance programs, private company employees need federal anti-retaliation protection for internal reporting.

B. *State Law Anti-Retaliation Protections' Insufficiencies*

One could argue that states, and not the federal government, should provide anti-retaliation protection for private company whistleblowers that only report internally. Though many states do have whistleblower laws, the lack of consistency among the states with respect to the breadth and scope of protection make these protections insufficient.¹²⁸

The main reason state protections are insufficient is because of the lack of consistency throughout the state laws.¹²⁹ Most importantly, not every state provides whistleblower protections.¹³⁰ As of 2009, Arizona, Arkansas, Texas, and the District of Columbia were among the thirteen states and federal districts that provided no whistleblower protections whatsoever.

States that do provide state whistleblower protections have a variety of differences.¹³¹ Some states only protect state or government employees.¹³² Others

¹²⁷ See generally McKown, Dailey & Green, *supra* note 45, at 199.

¹²⁸ Nat'l Conference of State Legislatures, *State Whistleblower Laws*, NAT'L CONF. OF ST. LEGISLATURES, <http://www.ncsl.org/issues-research/labor/state-whistleblower-laws.aspx> (last updated Nov. 2009).

¹²⁹ Elizabeth Mihalek, Note, *The Employee-Whistleblower and the Decision to Expose Corporate Fraud: Show Me the Money*, 17 No. 4 PIABA B.J. 401, 402 (2010).

¹³⁰ Nat'l Conference of State Legislatures, *supra* note 128.

¹³¹ *Id.*; Mihalek, *supra* note 129, at 406 (stating that state laws provided "piecemeal" protection).

¹³² Nat'l Conference of State Legislatures, *supra* note 128.

protect employees of all types (including privately held companies). Still others only protect health care employees.¹³³

In addition to differing on the type of employers the whistleblower laws apply to, states differ on the type of protections provided. Some states, even those that apply to all employers, only protect employees if they report a violation to a government or law enforcement agency.¹³⁴ Others mandate internal reporting.¹³⁵ Based on the variety of inconsistent state approaches to whistleblower protections, including thirteen states that provide no protection at all, clearly most private company whistleblower employees that want to report internally cannot rely on state protections. Moreover, private company employers cannot rely on state law protections to protect the integrity of their internal compliance programs. Even with the limited protections in some states, a well-informed whistleblower will surely bypass its employer's internal compliance program and report directly to the SEC in order to be eligible for the federal bounty and anti-retaliation protection.

C. Internal Anti-Retaliation Policies Insufficient

In response to Dodd-Frank's Bounty Program, many commentators have urged companies to enhance their internal compliance systems.¹³⁶ However, even though there may be robust internal compliance policies, well-informed prospective private company whistleblowers will likely bypass internal compliance and report directly to the SEC to: (1) receive federal anti-retaliation protection (i.e. an economic reinstatement award) or (2) become eligible for a large bounty. Even though creating strong internal compliance systems is a noble goal, the current state of the law practically mandates private company employees to undermine such goal.

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ See McKown, Dailey & Green, *supra* note 45; Berkenblit & Louizos, *supra* note 98.

VIII. SOLUTION

A. *Provide Internal Anti-Retaliation Protection for Private Company Employees*

The best solution is to provide federal anti-retaliation protection to private company employees that report internally. While there are critics of Dodd-Frank's extension of anti-retaliation protection to private company employees because of the increase in cost to the federal government,¹³⁷ extending protection to private company whistleblowers that report internally should not add to this cost. This is because a well-informed whistleblower would report to the SEC either at the same time or before reporting internally. Since this whistleblower would likely report to the SEC at some point, the federal government will not avoid that anti-retaliation cost.¹³⁸

More importantly, extending federal anti-protection to private company whistleblowers that report internally helps prevent the destruction of private company internal compliance programs. This is because providing prospective whistleblower employees with a federal economic reinstatement award incentivizes them to report internally to a higher degree than the current law. Without this added protection, the incentives Dodd-Frank creates for private company employees to report to the SEC will likely breakdown internal compliance programs.¹³⁹

B. *Eliminate Private Companies from Dodd-Frank Altogether*

At present, well-informed private company whistleblowers practically have no other option than to report to the SEC either before or at the same time they report internally. This is mainly due to the Bounty Program and the federal anti-retaliation protections described above. As previously stated, this leaves private company internal compliance programs hopeless. Thus, if Congress does not pass federal anti-retaliation protection for private company employees that report internally, it should not provide any federal protection or bounties to private company employees. Though this solution is harsh, and should not be the first choice, it may be necessary in order to preserve the integrity of private company internal compliance programs.

C. *Middle Ground—"Big Enough" Private Company*

The typical rationale for limiting protections to publicly traded employees is that securities fraud at private companies does not pose a threat to society.¹⁴⁰ In other words, public dollars should not be spent on protecting private companies.

¹³⁷ Ebersole, *supra* note 107, at 144–45.

¹³⁸ This is unless, of course, prospective private company whistleblowers with federal anti-retaliation protection would be more likely to report internally than to the SEC. This is something that would have to be determined after the protection was afforded.

¹³⁹ See McKown, Dailey & Green, *supra* note 45, at 199.

¹⁴⁰ Ebersole, *supra* note 107, at 144.

However, private companies are rapidly increasing in size. Household names, such as MARS (and, until recently, Facebook), are privately held companies.¹⁴¹ An unrevealed fraud at these companies, which would result in many losses in jobs, could be as detrimental to society as the downfall of Enron. Thus, if Congress will not provide federal anti-retaliation protection to all private company whistleblowers that report internally, it should at least provide it to privately held companies that are “big enough.”

This test could be similar to the test in section 12(g) of the Securities and Exchange Act of 1934.¹⁴² Section 12(g) provides that a company must register with the SEC and submit to its continuous disclosure system if it has both: (1) ten million dollars of assets and (2) five hundred shareholders of record.¹⁴³ Many companies, such as Facebook, have avoided section 12(g) requirements because of the five hundred shareholders of record requirement.¹⁴⁴ Therefore, I would propose a similar, but different, test to determine if a private company is “big enough” so that its employees could be provided anti-retaliation protection for reporting internally.

Rather than have two-pronged test as section 12(g) of the Exchange Act does, I suggest that if the private company has a certain amount of assets, or a certain number employees, or meets a combination of both requirements, then its employees could have federal anti-retaliation protection for internal reporting. This “size” test makes sense even under the rationale that the federal government should only protect the public. This is because bigger companies have more assets and employ more people and thus, securities fraud within larger private companies will have a large impact on the economy and employment as a whole. If Congress provides federal anti-retaliation protection to private company employees that report to the SEC, then it should also provide federal anti-retaliation protection to private company employees who report internally. However, if Congress must draw a line due to the public protection rationale, then a size test of this sort makes the most sense.

¹⁴¹ Andrea Murphy, *America's Largest Private Companies: Food* (Nov. 17, 2011, 7:37 AM), FORBES.COM, <http://www.forbes.com/sites/andreamurphy/2011/11/17/americas-largest-private-companies-food/>; see generally Samuel Wolf, *Trading Restricted Securities of Private Companies – Part 1*, 33 No. 6 SEC. & FED. CORP. L. REP. 1 (2011).

¹⁴² Securities and Exchange Act of 1934, 15 U.S.C.A. § 78l(g) (West, Westlaw through P.L. 112-207).

¹⁴³ *Id.* Recently passed legislation made a few changes to this test. For more information on the changes made, see *Jumpstart Our Business Startups Act Frequently Asked Questions: Changes to the Requirements for Exchange Act Registration and Deregistration*, U.S. SEC. & EXCHANGE COMMISSION (April 11, 2012), <http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-12g.htm>. The revisions made do not change the underlying analysis of this proposed solution.

¹⁴⁴ See generally Wolf, *supra* note 141.

IX. CONCLUSION

There is no doubt that whistleblowers play a critical role in revealing and preventing corporate fraud. Thus, it is necessary to provide prospective whistleblower employees with incentives to blow the whistle. It seems the most important incentive, due partly to inconsistent state law protections and employer retaliation, is to provide whistleblowers with federal anti-retaliation protection.

Even though it is important to encourage prospective whistleblowers to blow the whistle, the incentives provided should not encourage whistleblowers to undermine their companies' internal compliance system. The combination of a lack of internal reporting protection for private company employees, and the incentives Dodd-Frank creates for private company employees to report to the SEC, do just that—they practically leave well-informed private company whistleblowers with no choice but to undermine their company's internal compliance system. This problem does not exist to the same extent for public company employees because SOX provides whistleblowers with at least some protection for internal reporting.

In order to fix the private company internal reporting loophole created by the current whistleblower laws, Congress must provide private company employees with at least as much federal anti-retaliation protection as public company employees receive under SOX. If Congress chooses not to afford private company employees with federal anti-retaliation protection for internal reporting, then the Dodd-Frank Bounty Program and federal private right of action should not apply to them either. However, since many private companies are just as important to the public as many public companies are, if Congress chooses not to provide federal anti-retaliation protection for internal reporting to all private companies, then it should at least provide such protection to those companies that are "big enough." If one of these solutions is not implemented, then it is only a matter of time before private company employees begin to become aware of the current whistleblower laws and incentives, and private companies' internal compliance systems collapse.