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Securities & Corporate Governance Litigation and White Collar Criminal Defense & Investigations Joint Alert

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New Dodd-Frank Wall Street Reform and Consumer Protection Act: Bounties for Assistance

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) significantly expands the financial incentives and protections for those "whistleblowing" to the Government, specifically the SEC. Although regulations have not yet been promulgated under the Act, the Act makes the provisions relating to whistleblowers' financial rewards effective immediately. The key provisions are:

Rewards whistleblowers with 10 to 30 percent of monetary penalties in cases in which the SEC recovers over $1 million. To receive this reward, a whistleblower must be the "original source" of the information that leads to an SEC recovery.

Rewards whistleblowers for reporting violations of any federal securities law, including for example, the Foreign Corrupt Practices Act, the Investment Advisors Act, and the Investment Company Act. Additionally, the Act's provisions likely apply to employees of any company subject to the federal securities laws, not just public companies.

The Act allows employees who have been retaliated against for providing information to the SEC, or making disclosures required under the Sarbanes-Oxley Act of 2002 (SOX), to bring a private suit in federal court. Under SOX, such employees need to first exhaust administrative remedies by going through the Department of Labor. Additionally, the burden-shifting framework in the Act creates a favorable standard for the employee-plaintiff.

The Act significantly increases the time period within which a whistleblower can come forward with a retaliation claim. As opposed to the 180-day period provided by SOX, the Act allows employees to bring suit up to 10 years after the violation occurred.

The Act amends SOX to provide that subsidiaries and affiliates of publicly-traded companies, whose financial information is included in the consolidated financial statements of the publicly-traded company, are now covered by SOX. This means that employees of these entities have protection under the Act's whistleblower provisions if they report violations of the securities laws to the SEC.

All companies subject to the federal securities and commodities laws should consider revisiting their internal whistleblower procedures and policies. Employees now have a particularly strong financial incentive to report possible violations of the law. The whistleblower provisions of the Act may undermine typical internal reporting programs implemented in response to SOX. Companies must ensure that the appropriate reporting structure is in place to encourage employees to report problems internally rather than going directly to federal agencies. The implications to the company of an employee taking internal matters to the SEC before allowing the company the ability to investigate the matter on its own will be costly, time-consuming, and burdensome, even if the employee's concerns and information turn out to be unfounded.

Sixth Circuit Holds Plaintiffs to Stringent Standard in Pleading Scienter Against Outside Auditor

In the recently issued opinion of *Louisiana School Employees' Retirement System v. Ernst & Young, LLP,* No. 08-6194 (6th Cir. Sept. 22, 2010), the Sixth Circuit continued its trend to apply the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), as establishing a particularly high standard to plead scienter and fraud against a public company's outside auditors.

The Sixth Circuit affirmed the district court's dismissal of fraud claims based upon the standard articulated by the Supreme Court in *Tellabs*, *i.e.* that a complaint will survive a motion to dismiss only if "a reasonable person would deem the inference of scienter cogent and *at least as compelling* as any opposing inference one could draw from the facts alleged." Slip Op. at 10. The Sixth Circuit noted that, while liability in securities fraud claims can be premised on "recklessness," the "standard of recklessness is more stringent when the defendant is an outside auditor. In that case, recklessness requires a mental state so culpable that it approximates an actual intent to aid in the fraud being perpetrated by the audited company…the complaint must identify specific, highly suspicious facts and circumstances available to the auditor at the time of the audit and allege that these facts were ignored, either deliberately or recklessly." *Id.* at 9.

The Sixth Circuit held that allegations that Ernst &Young failed to include the appropriate data in its audit under GAAP did not create an inference of scienter. Regarding the allegations that Ernst &Young ignored red flags, the Court noted "for a red flag to create a strong inference of scienter in securities fraud claims against an outside auditor, it must consist of an egregious refusal to see the obvious, or to investigate the doubtful." *Id.* at 14. The Court discounted the argument that Ernst &Young was motivated to commit fraud by the promise of future professional fees noting that "allegations that the auditor earned and wished to continue earning fees from a client do not raise an inference that the auditor acted with the requisite scienter." *Id.* at 18. The Court further found that the magnitude of the accounting violations did not support an inference of scienter, stating "allowing such an inference would eviscerate the principle that accounting errors alone cannot support a finding of scienter." *Id.* at 17. Lastly, the Court found that allegations regarding post-class period events, such as Accredo's firing of Ernst &Young and filing of a malpractice action, were irrelevant to the analysis of scienter. *Id.* at 19.

Uncertainty Concerning Privilege Afforded Accountant Papers

There is a conflict in the Federal Circuits over what protection can be afforded to accountant papers prepared in anticipation of an IRS audit or prepared by a corporation for its auditor in order for the auditor to be able to certify the corporation's annual audit.

In a dispute concerning the IRS over the tax treatment of two Dow Chemical affiliates, the Third Circuit denied the Government's request for memoranda Dow Chemical provided Deloitte, its auditor, in order for Deloitte to certify Dow's annual audit. *United States v. Deloitte LLP*, 610 F.3d 129 (D.C. Cir. 2010). In upholding the privilege against disclosure of the information, the Court set forth a detailed discussion of attorney-client privilege, the work product doctrine applied, and the impact of disclosure to third-parties, such as an accountant. The opinion provides a "roadmap" for lawyers and accountants in protecting their advice from being disclosed to the Government.

In contrast, the First Circuit upheld the Government's request for similar types of materials and information, finding that the attorney-client privilege and the work product doctrine did not protect the materials from disclosure. *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009). These two cases collide on what protection can be assumed for an accountant's analysis of a corporation's risk of audit and how that protection is affected when the analysis forms part of the reasoning behind the auditor's certification of the corporation's annual audit. While it is difficult to reconcile these two cases, it is prudent to take steps set forth in the *Deloitte* decision in order to maximize the likelihood that the analysis would be protected from disclosure to the Government.