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WHISTLEBLOWERS

Necessary Precautions for PE Firms When Using Employee Agreements to Protect Confidential Business Information

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PE firms typically use a variety of agreements – *e.g.*, offer letters, along with employment, confidentiality and separation agreements – and written policies to protect valuable confidential business information accessible by their employees. Firms must be careful, however, that those agreements and policies do not inhibit their employees' rights to contact governmental agencies, including for the purposes of whistleblowing or filing claims. Negative consequences of overbroad language may include regulatory sanctions by the SEC and the invalidation of certain agreements by the Equal Employment Opportunity Commission (EEOC).

This article outlines the SEC's whistleblowing rules; summarizes key SEC and EEOC enforcement actions over the last several years for violations of the whistleblowing rules; and offers practical advice to PE firms on avoiding violations of applicable whistleblower rules.

Overview of Whistleblower Rules

In 2011, the Dodd-Frank Act amended the Securities Exchange Act of 1934 to add Section 21F, entitled "Securities Whistleblower Incentives and Protection." Section 21F has three mechanisms designed to encourage whistleblowers to report possible securities law violations:

1. financial incentives (*i.e.*, whistleblower awards);
2. a prohibition on employment-related retaliation for whistleblowing; and
3. various confidentiality guarantees.

In August 2011, the SEC adopted Rule 21F-17, which provides, among other things, "No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications."

Beginning in 2015, the SEC began taking – and acting on – the view that any provisions that might stifle an employee's communications with the SEC are prohibited, regardless of the employer's intent, its efforts (or lack thereof) to enforce them or their actual chilling effect (or lack thereof).

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See "Sanctions Against Private Fund Manager for Retaliating Against Whistleblower Highlight the Importance of Incentivizing Internal Reporting" (Jul. 18, 2014).

KBR Settlement

On April 1, 2015, the SEC announced a settlement with Texas engineering firm KBR, Inc. (KBR) that the SEC billed as "its first enforcement action against a company for using improperly restrictive language in confidentiality agreements with the potential to stifle the whistleblowing process."

KBR had required witnesses interviewed in internal investigations to sign a confidentiality statement that included language warning that they could face discipline "up to and including termination of employment" for "discussing any particulars regarding this interview and the subject matter discussed during the interview" without prior authorization from KBR's law department.

See "Asset Managers Must Adapt to Increasing Protections for Internal Whistleblowing Under Dodd-Frank" (May 18, 2017).

In its consent order, the SEC found that the above language impeded communications with SEC staff about potential securities law violations and undermined the purposes of Section 21F and Rule 21F-17(a), namely to encourage reporting to the SEC. The settlement was entered into despite the SEC acknowledging there was no sign that KBR had taken any action to enforce those confidentiality agreements, or that any KBR employee was dissuaded or otherwise actively prevented by KBR from communicating directly with the SEC.

As part of the settlement with the SEC, KBR paid a $130,000 civil monetary penalty and amended its confidentiality provision to include the following language:

> Nothing in this Confidentiality Statement prohibits me from reporting possible violations of federal law or regulation to any governmental agency or entity, including but not limited to the Department of Justice, the Securities and Exchange Commission, the Congress, and any agency Inspector General, or making other disclosures that are protected under the whistleblower provisions of federal law or regulation. I do not need the prior authorization of the Law Department to make any such reports or disclosures and I am not required to notify the company that I have made such reports or disclosures.

SEC Warnings About Broader Concerns

Immediately after announcing the KBR settlement, the SEC made clear that not just confidentiality agreements are in its crosshairs.

At the end of April 2015, then-SEC Chair Mary Jo White stated that:

> a number of other concerns have come to our attention, including that some companies may be trying to require their employees to sign agreements mandating that they forego any whistleblower award or represent, as a precondition to obtaining a severance payment, that they have not made a prior report of misconduct to the SEC.

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White went on to warn that these provisions would face scrutiny by the SEC's Division of Enforcement. The SEC also has indicated publicly that it is targeting not only firms that use offending provisions, but the personnel at those firms involved in crafting them – potentially including in-house legal and compliance personnel.

An October 2016 risk alert issued by the SEC Office of Compliance Inspections and Examinations announced the SEC would be reviewing employment documents – including, "among other things, compliance manuals, codes of ethics, employment agreements, and severance agreements" – to determine whether they contain provisions:

> that *may* contribute to violations of Rule 21F-17 in circumstances where their use *impedes* employees or former employees from communicating with the Commission, such as provisions that: (a) require an employee to represent that he or she has not assisted in any investigation involving the registrant; (b) prohibit any and all disclosures of confidential information, without any exception for voluntary communications with the Commission concerning possible securities laws violations; (c) require an employee to notify and/or obtain consent from the registrant prior to disclosing confidential information, without any exception for voluntary communications with the Commission concerning possible securities laws violations; or (d) purport to permit disclosures of confidential information only as required by law, without any exception for voluntary communications with the Commission concerning possible securities laws violations.

Additional SEC Enforcement Actions

The SEC has made good on these warnings, targeting agreements that could limit employees' abilities to communicate with the SEC or interfere with their rights to monetary awards for reporting wrongdoing to governmental agencies.

For example, the SEC pursued a claim involving severance agreements that prohibited departing employees from disclosing any confidential information, except in a formal legal process.[1] In that situation, the firm had also adopted revised forms of severance agreements that advised the departing employee that the agreement did not prohibit initiating communications directly with the SEC or other authorities, but limited the types of information that could be conveyed to information relating to the severance agreement itself or "its underlying facts and circumstances."

In a separate incident, the SEC brought an action against a company's severance agreements that prohibited employees from sharing confidential information with anyone unless compelled to do so by law and with sufficient notice of the disclosure to the company. Those severance agreements also acknowledged the employee's right to file a claim with the SEC (or the EEOC) but stated that the employee was "waiving the right to any monetary recovery in connection with any such complaint or charge that Employee may file with an administrative agency." The SEC found that financial waiver deprived employees of Section 21F's "critically important financial incentives" for employees to engage in whistleblowing.[2]

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In addition, the SEC's enforcement actions have also targeted:

- a severance agreement stating that employees were free to participate in any investigation with a governmental agency, but that they waived any right to monetary recovery in such a proceeding;[3]
- a severance agreement that broadly prohibited the employee from disclosing any confidential information, and imposed liquidated damages of $250,000 for breaching this obligation;[4]
- a non-disparagement clause in a severance agreement that expressly prohibited former employees from communicating with the SEC and other governmental agencies;[5]
- severance agreements that prohibited former employees from voluntarily contacting governmental agencies with any complaint, participating in a government investigation, being paid as a result of a government investigation, providing confidential information to the government or disparaging the company to any governmental agency;[6] and
- a severance agreement purporting to waive an employee's right to a monetary recovery for reporting misconduct under the Dodd-Frank Act.[7]

EEOC Actions

The EEOC has the right to assert claims in its own name based on discrimination experienced by an employee, irrespective of whether the employee has released all claims against the employer.

Accordingly, although a release generally precludes an employee from obtaining individual relief based on employment discrimination, the EEOC takes the position that severance agreements and contractual provisions (*e.g.*, releases, confidentiality provisions and non-disparagement provisions) cannot expressly prevent an employee from filing a claim with the EEOC or communicating with it. Those provisions must also make clear that nothing in the agreements or provisions prevents the employee from doing so.

The EEOC takes the position that releases of federal discrimination claims in severance agreements that fall afoul of this rule are void.[8] Obviously, it would be disappointing for an employer to pay severance to a departing employee in return for a release of discrimination claims, only to find that it were void and that the severance agreement were the basis of an EEOC action against the employer.[9]

See "Proskauer Attorneys Evaluate the Dodd-Frank Whistleblower Program and Its Future Under the Trump Administration" (Jun. 1, 2017).

Takeaways for PE Firms

Given the nature of their business, PE firms routinely possess confidential information that they have legitimate business interests in protecting.

In light of the positions of the SEC and EEOC, firms should review employment documents – including offer letters, employment agreements, confidentiality agreements, human resources policies and severance agreements – that they and their portfolio companies use, to ensure compliance with these issues. Specifically, firms should confirm that they do not expressly "impede" employees from filing claims with, or bringing information

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to the attention of, any governmental agency (*e.g.*, the SEC, EEOC, etc.), or from receiving SEC whistleblower awards.

In addition, because those same types of documents may contain implicitly "impeding" provisions – *e.g.*, cooperation agreements, confidentiality obligations, non-disparagement provisions, releases and covenants not to sue – firms also should include clear language stating that they do not prevent those protected actions. To that end, firms should consider including the following language in relevant agreements and policy manuals to address these types of concerns:[10]

> NOTHING IN THIS AGREEMENT INCLUDING [insert reference to sections containing release, confidentiality, non-disparagement, cooperation, and any other potentially "impeding" provisions] PREVENTS YOU FROM COMMUNICATING WITH OR FILING A CHARGE OR COMPLAINT WITH THE SECURITIES AND EXCHANGE COMMISSION ("SEC"), EQUAL EMPLOYMENT OPPORTUNITY COMMISSION ("EEOC"), OR THE NATIONAL LABOR RELATIONS BOARD, OR ANY OTHER GOVERNMENTAL AGENCY; OR FROM PROVIDING TRUTHFUL INFORMATION IN THE COURSE OF AN INVESTIGATION OR PROCEEDING CONDUCTED BY THOSE AGENCIES OR ANY OTHER FEDERAL, STATE OR LOCAL AGENCY CHARGED WITH THE ENFORCEMENT OF ANY LAWS; OR FROM SEEKING OR OBTAINING ANY WHISTLEBLOWER AWARD FROM THE SEC OR ANY OTHER FEDERAL, STATE OR LOCAL AGENCY CHARGED WITH THE ENFORCEMENT OF ANY LAWS. BY SIGNING THIS AGREEMENT, HOWEVER, AND TO THE GREATEST EXTENT PERMITTED BY APPLICABLE LAW, YOU ARE WAIVING YOUR RIGHT TO MONEY DAMAGES OR ANY OTHER INDIVIDUAL RELIEF BASED ON CLAIMS FILED WITH THE EEOC OR ANY OTHER GOVERNMENTAL AGENCY CHARGED WITH THE ENFORCEMENT OF EMPLOYMENT ANTIDISCRIMINATION LAWS, WHETHER FILED BY YOU OR ANY OTHER PERSON OR ENTITY, ON THE BASIS THAT ANY SUCH CLAIMS HAVE BEEN FULLY AND COMPLETELY SATISFIED BY THE SETTLEMENT PAYMENT.

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[1] In the Matter of Merrill Lynch, Pierce, Fenner & Smith Inc., SEC File No. 3-17312 (June 23, 2016).

[2] *In the Matter of BlueLinx Holdings Inc.*, SEC File No. 3-17371 (Aug. 10, 2016).

[3] *In the Matter of Health Net, Inc.*, SEC File No. 3-17396 (Aug. 16, 2016).

[4] In the Matter of Anheuser-Busch InBev SA/NV, SEC File No. 3-17586 (Sept. 28, 2016).

[5] *In the Matter of NeuStar, Inc.*, SEC File No. 3-17736 (Dec. 19, 2016).

[6] *In the Matter of SandRidge Energy, Inc.*, SEC File No. 3-17739 (Dec. 20, 2016).

[7] *In the Matter of BlackRock, Inc.*, SEC File No. 3-17786 (Jan. 17, 2017).

[8] Enforcement Guidance on non-waivable employee rights under EEOC enforced statutes, No. 915.002 (Apr. 10, 1997); EEOC v. Eastman Kodak Co., Case No. 06-cv-6489 (W.D.N.Y. 2006); EEOC v. Lockheed Martin, 444 F. Supp. 2d 414 (D. Md. 2006); EEOC Strategic Enforcement Plan FY 2013-2016 at 10 (Dec. 17, 2012).

[9] See, *e.g.*, EEOC v. CVS Pharmacy, Inc., 809 F.3d 335 (7th Cir. 2015).

[10] *See In the Matter of KBR, Inc.*, SEC File No. 3-16466 (Apr. 1, 2015); *EEOC v. Eastman Kodak Co.*, No. 06-cv-6489 (W.D.N.Y. 2006), Consent Decree. Although it is beyond the scope of this article, the authors also note that the federal Defend Trade Secrets Act of 2016 requires employers to notify employees of the immunity from liability granted them by that statute under certain circumstances. *See* 18 U.S.C. § 1831 et seq.

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